22nd ANNUAL

PRIVATE INVESTMENT FUNDS SEMINAR

Schulte Roth & Zabel

TUESDAY
JANUARY 15
2013

Schulte Roth&Zabel

Main Program

Welcome Remarks
Paul Roth

Regulatory Examinations and Enforcement
Brian Daly, Harry Davis, Marc Elovitz, Steven Fredman, Howard Schiffman, Sung-Hee Suh

Tax Considerations for 2013
Alan Waldenberg

Capital Raising in 2013
David Efron, Jason Kaplan, David Nissenbaum

US Managers Marketing in Europe: AIFM and Beyond
Josh Dambacher, Christopher Hilditch

Opportunities for Hedge Fund Managers in the Registered Funds Space
Kenneth Gerstein, Daniel Hunter, Shlomo Twerski

Current Developments in the Secondary Market for Fund Interests
Philippe Benedict, Stephanie Breslow, John Pollack, Joseph Smith

Building an Investment Management Firm
Boaz Weinstein, Saba Capital and Daniel Stern, Reservoir Capital Group
Moderated by Paul Roth

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Practices

Tax

Real Estate Capital Markets & REITs

Philippe Benedict

Philippe focuses his practice on the tax aspects of investment funds, mergers and acquisitions, international transactions, real estate transactions and financial instruments.

Philippe has advised on many major transactions involving sales or spinoffs of investment fund managers, and advised Prisma Capital Partners in its acquisition by global investment firm KKR & Co. Philippe's other recent representations include: advising Scopia Fund Management LLC in its sale of a passive minority interest to Neuberger Berman Group-managed private equity fund Dyal Capital Partners; advising MKP Capital Management LLC on an investment by Dyal; generally advising Mount Kellett Capital Management LP on the tax structuring of its worldwide investments; representing Toronto-based Oxford Properties Group in connection with its joint venture with Related Companies for the development, leasing and funding of Hudson Yards; and advising multiple alternative asset managers on the formation and structuring of many funds during the past year.

A frequent speaker at prominent industry events, Philippe recently spoke on "Best Practices in Succession Management" at the Managed Funds Association's *Key Components of Building a Succession Plan for Your Hedge Fund* seminar, "FATCA and Dividend Equivalent Withholding Developments" at an SRZ *Investment Management Hot Topics* program and "How Will New Tax Changes Affect Hedge Funds in 2012?" at Bank of America Merrill Lynch's *Deciphering the New Regulatory and Tax Environment seminar*.

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

Investment Management
Financial Institutions
Hedge Funds
Private Equity

Stephanie R. Breslow

Stephanie is co-head of Schulte Roth & Zabel's Investment Management Group and a member of the firm's Executive Committee. Her practice includes investment management, partnerships and securities, with a focus on the formation of 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 the Practising Law Institute, contributed a chapter on "Hedge Funds in Private Equity" for inclusion in *Private Equity* (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.

Recently named vice-chair of the Private Investment Funds Subcommittee of the International Bar Association, Stephanie is a founding member and former chair of the Private Investment Fund Forum, a member of the Advisory Board of Third Way Capital Markets Initiative, a 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 the *Euromoney Legal Media Group*'s "Best in Investment Funds" at the inaugural Americas Women in Business Law Awards. She is also listed in *Chambers USA*, *Chambers Global*, *The Legal 500 United States*, *Best Lawyers in America*, *America's Leading Lawyers*, *Who's Who Legal: The International Who's Who of Business Lawyers* (which ranked her one of the world's "Top Ten Private Equity Lawyers"), *Who's Who Legal: The International Who's Who of Private Funds Lawyers* (which placed her on its "Most Highly Regarded Individuals" list), *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. Additionally, Stephanie was recognized by the Girl Scouts of Greater New York as one of 2012's Women of Distinction.

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

Investment Management

Hedge Funds

Private Equity

Regulatory & Compliance

Brian T. Daly

Brian focuses on advising hedge and private equity fund managers on regulatory, compliance and operational matters, including registration and disclosure obligations, trading issues, advertising and marketing and the establishment of compliance programs.

Having spent nearly a decade serving in-house as general counsel and chief compliance officer at several prominent hedge fund firms, Brian is well-versed in a wide range of legal and business challenges facing investment advisers and other financial services entities and has represented clients in proceedings and interactions with regulators in the U.S., the U.K. and Asia. He also has extensive experience interfacing with internal and external resources to design and improve processes and organizational systems.

Brian is well-known for his thought leadership in the regulatory and compliance area as it affects alternative investment funds, and he recently co-authored “FSA Conflicts of Interest Safeguards: Action To Be Taken by All UK-Authorised Hedge Fund Managers” for *The Hedge Fund Journal*. Brian has also served as co-chair of the Managed Funds Association’s General Counsel Forum and as a steering committee member of its Investment Advisory Committee. He is a visiting lecturer at Yale Law School, where he teaches a class on legal ethics, and frequently speaks on industry panels and at educational outreach events.

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

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Practices

- Investment Management
- Financial Institutions
- Hedge Funds
- Private Equity
- Regulatory & Compliance
- Shareholder Activism

Josh Dambacher

Josh 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, as well as 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 "What Hedge Fund Managers Need to Know About the JOBS Act" for AIMA's *JOBS Act* seminar and "Safety in Numbers: Change, Consolidation and M&A in the Hedge Fund Space" for the *HFMWeek Legal Summit*. He previously led the U.S. Financial Reforms Working Group for the Alternative Investment Management Association and is listed as a leading investment management attorney by *PLC Which Lawyer* and *Chambers UK*, where he is recognized by *Chambers UK* interviewees as "pragmatic and commercial in his outlook" and "always reachable no matter what."

Josh holds a J.D. from the University of Michigan Law School and an M.B.A. 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

- Litigation
- Financial Institutions
- Hedge Funds
- Regulatory & Compliance
- Securities Enforcement & White Collar Defense

Harry S. Davis

Harry focuses on complex commercial litigation and regulatory matters 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 DOJ, 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 highly sought-after speaker and prolific author in his area of expertise, Harry serves as the editor of the *Insider Trading Law and Compliance Answer Book*, published by Practising Law Institute. He also authored three chapters in the book: "Overview of the Law of Insider Trading," "Materiality" and "Breach of Duty: Misappropriation Theory."

Harry graduated with a J.D., *magna cum laude*, from Cornell Law School, where he was 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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Practices

Investment Management

Hedge Funds

Regulatory & Compliance

David J. Efron

David practices in the areas of domestic and offshore hedge funds, including fund formations and restructurings. Additionally, he advises hedge fund managers on structure, compensation and various other matters relating to their management companies, and structures seed capital and joint venture arrangements. David also represents hedge fund managers in connection with SEC regulatory issues and compliance-related matters.

David is listed in *Who's Who Legal: The International Who's Who of Private Funds Lawyers* and 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."

A published author on subjects relating to investment management, David also is a sought-after speaker for hedge fund industry conferences and seminars, and a frequent guest lecturer at New York-area law and business schools. Some of his recent presentations include "Navigating Institutional Investor Due Diligence and Best Practices for Hedge Funds" for the Hedge Fund Cares Seminar and "Potential Impact of the JOBS Act on the Hedge Fund Industry" for a Goldman Sachs webinar.

David received his LL.M. in securities regulation, with distinction, from Georgetown University Law Center, his J.D. from Syracuse University College of Law and his B.A. from Vassar College.

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Practices

Regulatory & Compliance

Hedge Funds

Investment Management

Litigation

Marc E. Elovitz

Marc chairs Schulte Roth & Zabel's Investment Management Regulatory & Compliance Group and advises private fund managers on compliance with the Investment Advisers Act of 1940 and other federal, state and self-regulatory organization requirements, including establishing compliance programs, registering with the SEC and CFTC, and handling SEC and NFA examinations. Marc provides guidance to clients on securities trading matters and represents them in regulatory investigations and enforcement actions, arbitrations and civil litigation. He also regularly leads training sessions for portfolio managers, analysts and traders on complying with insider trading and market manipulation laws, and has developed and led compliance training sessions for marketing and investor relations professionals.

Recently, Marc has been working closely with clients undergoing SEC examinations and responding to deficiency letters and enforcement referrals. He has been developing new compliance testing programs in areas such as trade allocations and conflicts of interest. He also 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.

Marc is a frequent speaker at hedge fund industry conferences and seminars and recently discussed "Increasing Demands for Transparency: Form PF, OPERA, AIFMD" at Deutsche Bank's *Global Prime Finance Hedge Fund Conference* and "Preparing Your Organization for Form PF" at the Goldman Sachs *Fifteenth Annual Hedge Fund Conference*. He addressed "Securities Law Compliance — Insider Trading" at Columbia Business School's *Private Equity* program, "The SEC Exam Process and Compliance Concerns" for the Managed Funds Association's *SEC Compliance Priorities* seminar and "The Challenges of Regulatory Implementation Faced by Private Investment Funds and Their Managers" at the New York City Bar Association. He moderated discussions with staff of the SEC's Division of Investment Management at an ABA Business Law Section meeting and on the ABA webinar "SEC Registration of Investment Advisers."

Marc 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*. He also is the co-author of the "Protecting Your Firm Through Policies and Procedures, Training and Testing" chapter in the *Insider Trading Law and Compliance Answer Book* published by Practising Law Institute, and an article on "The SEC's New Presence Examinations" in the *Investment Lawyer*. Marc is frequently quoted in the media on hedge fund regulation and he authors a quarterly column on hedge fund topics of interest for *HFMWeek*.

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

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

Steven J. Fredman

Steve is 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 advisers, 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 presented a “Regulatory Update” at the Morgan Stanley annual *Chief Operating & Chief Financial Officer Forum* and “Hedge Fund Challenges from the Hedge Fund Perspective” at SIFMA’s *2012 Compliance and Legal Society Annual Seminar*. He also co-authored “The Consent Conundrum: Changing Control of U.S. Alternative Investment Advisers” for *Bloomberg Law*. 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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Regulatory & Compliance

Ken focuses his practice on representing investment advisers, broker-dealers and banks in connection with the organization and operation of investment funds, including mutual funds, hedge funds, closed-end investment companies, business development companies and bank collective investment funds. He also represents these firms in connection with the development of other types of investment-related products and services. Ken has worked with clients in developing numerous novel and hybrid fund products, including mutual funds that pursue alternative investment strategies, registered hedge funds. registered hedge funds of funds and multi-manager mutual funds. He also advises clients on a broad range of securities, regulatory and compliance matters, and represents mutual fund independent directors. Prior to entering private practice, Ken served as special counsel in the SEC's Division of Investment Management in Washington, DC.

Ken is a frequent author and speaker on issues related to investment funds and investment advisers, having appeared at conferences sponsored by the Practising Law Institute, ALI-ABA, the Investment Company Institute and other organizations. He is a member of the American Bar Association's Committee on the Federal Regulation of Securities and a member of its Subcommittee on Investment Companies and Advisers. Ken also is a member of the New York City Bar Association's Committee on Investment Management Regulation.

Ken obtained an LL.M. from Georgetown University Law Center, a J.D. from the James E. Beasley School of Law at Temple University, where he was a member of the *Temple Law Quarterly*, and a B.S. in economics from the Wharton School of the University of Pennsylvania.

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Practices

- Investment Management
- Financial Institutions
- Hedge Funds
- Regulatory & Compliance

Christopher Hilditch

Chris is the head of Schulte Roth & Zabel's London office. He advises a wide range of institutional and entrepreneurial managers on structuring and establishing investment funds, particularly 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. Articles include "FSA Conflicts of Interest Safeguards: Action To Be Taken by All UK-Authorised Hedge Fund Managers" and "New European Rules on Short Selling — Effective 1 November 2012" in *The Hedge Fund Journal*, "Hedge Funds — A European Perspective" in *The Asset Growth Guide* and "Hedge Fund Structure — Some Key Legal Considerations" in *A Guide to European Hedge Funds*. He also contributed to *Investment Management: Law and Practice*, published by Oxford University Press. Chris's recent speaking engagements include "If I Only Knew Then What I Know Now...the Current Business Priorities of Hedge Fund COOs" at HFMWeek's *Operational Leaders Summit* and "Starting a Hedge Fund? All You Need to Know" for a Bloomberg seminar.

Chris is 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*, and 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

Investment Management

Hedge Funds

Private Equity

Regulatory & Compliance

Daniel F. Hunter

Dan concentrates his practice on the design, structure and regulation of alternative investment products, including hedge funds, hybrid 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, merger and acquisition and restructuring advice to his fund clients, and advises funds regarding the receipt or allocation of seed capital. As part of his compliance practice, Dan advises clients on the Treasury Forms (TIC Forms), the CFTC rules and regulations, as well as the recently adopted Form PF.

A sought-after speaker, Dan recently discussed "New Private Placement Rules Under the JOBS Act" at a Financial Executives Alliance event and presented "Compliance and CFTC Issues for Brazilian Managers" at the Goldman Sachs *Prime Brokerage Conference* in São Paulo. Additionally, he co-authored "New European Rules on Short Selling — Effective 1 November 2012," which was published in *The Hedge Fund Journal*. Dan has been recognized in *The Legal 500 USA* in the Investment Fund Formation and Management category.

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

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

Jason concentrates on investment management and related regulatory and compliance matters, advising on general corporate, securities and compliance issues for investment advisers and investment funds. Jason's practice focuses on advising managers of hedge, private equity and hybrid funds regarding the structure of their businesses and on day-to-day operational, securities, corporate and compliance issues; structuring and negotiating seed and strategic investments and relationships; and advising investment managers with respect to regulatory and compliance issues.

Among recent speaking and writing engagements, Jason participated in the "Form PF Masterclass" at Credit Suisse's *European Hedge Fund Thought Leadership Conference* and presented at the "Prime Brokerage Form PF Workshop" as part of a Goldman Sachs seminar. He also co-authored "Dodd-Frank Becomes Law: Key Issues for Private Fund Managers" for *The Hedge Fund Journal*.

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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Practices

Investment Management

Financial Institutions

Hedge Funds

Private Equity

David Nissenbaum

David is a member of Schulte Roth & Zabel's Investment Management and Financial Institutions practice groups and a member of the firm's Executive Committee. His practice focuses on corporate, bank regulation and securities matters and he primarily represents institutional and entrepreneurial investment managers, financial services firms and private investment funds in all aspects of their business.

David structures and advises investment management and financial services firms as well as hedge, private equity and hybrid funds, funds of funds and scalable platforms for fund sponsors. He also advises on succession planning, mergers and acquisitions of investment firms and on all aspects of U.S. banking laws that affect investment and financial services firms and investment funds, including investments in banking organizations, bank-sponsored funds and investments in funds by banking organizations.

A member of the Advisory Board of The Financial Executives Alliance and past member of the Banking Law Committee of the New York City Bar Association, David is a sought-after writer and speaker in his areas of expertise. He recently co-authored "Hedge Fund Names: What a Hedge Fund Manager Should Do Before It Starts Using a Name" for *The Hedge Fund Law Report*. "Just Like Starting Over: A Blueprint for the New Wall Street Firm," published by *The Deal*, "Hedge Fund Manager Succession Planning" and "Federal Reserve Provides Greater Flexibility for Non-Controlling Investment in Banks and Bank Holding Companies" are among his other publications. David has spoken recently on "Best Practices for Strong, Effective Fund Governance" at the *Corporate Counsel 6th Annual Hedge Fund General Counsel Summit* and discussed "Succession Planning for Fund Managers" at the MFA *Key Components of Building a Succession Plan for Your Hedge Fund* seminar.

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

Mergers & Acquisitions
Private Equity

John 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. Highlights of John's work include the merger of Charming Shoppes Inc. with Ascena Retail Group Inc., a transaction named the 2012 "North America Corporate Deal of the Year" by *Global M&A Network*, and the merger of DynCorp International Inc. with an affiliate of Cerberus Capital Management LP, a transaction which was selected by *The Deal* as one of 2010's "Private Equity Deals of the Year."

John is the co-principal author of the *SRZ Large Market and Middle Market PE Buyer/Public Target M&A Deal Studies*, which detail and compare the notable trends and themes in recent mergers and acquisitions involving private equity buyers and public company targets in the large market and middle market sectors. He also recently co-authored "Mergers Move 'Two Steps' Quicker" for *PE Manager*. John's recent speaking engagements include "Private Equity in Flux" at the Ohio State University *Corporate Law and Capital Markets Project 2012 M&A Roundtable* and *"Deal Protections: Latest Trends and Best Practices,"* CLE International 5th Annual Private Equity Conference.

John received 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. He is currently 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.

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Practices

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Private Equity
Regulatory & Compliance
Securities & Capital Markets

Paul N. Roth

Paul is a founding partner of Schulte Roth & Zabel and chair of its Investment Management Group. Throughout his career, he has acted as counsel to leading public and private companies in financial services and to their boards of directors. Paul's extensive private investment funds practice, an area in which he has more than 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, 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 Fund and the Advisory Board of the RAND Center for Corporate Ethics and Governance, and he is a fellow of the New York Bar Foundation and the Phi Beta Kappa Society. He served on the Advisory Board of Harvard Law School's Center on Lawyers and the Professional Services Industry and formerly served as president and a trustee of the Harvard Law School Alumni Association of New York City. Additionally, Paul is an adjunct professor at New York University's Stern School of Business, where he co-teaches a course on "Managing Financial Businesses: Responding to Change in a More Challenging Regulatory Environment."

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

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Practices

Litigation

Regulatory & Compliance

Securities Enforcement & White Collar Defense

Howard Schiffman

Howard is co-chair of Schulte Roth & Zabel's 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.

A corporate problem solver, Howard is adept at dispute containment and resolution as well as at arguing to a jury. He counsels clients, including hedge funds and their managers and directors, the leading prime brokers and clearing firms, fund administrators and other major financial institutions, in risk analysis and litigation avoidance. For example, last year he persuaded the SEC to close without action an investigation into a fund administrator after the SEC staff had issued a Wells notice — before Howard was engaged — alleging the administrator mismarked positions. In a separate matter last year, Howard negotiated a very favorable settlement of a dispute among two former partners in a hedge fund management firm after securing significant interim rulings in parallel federal and state litigation.

With his extensive trial experience and solid record of success in numerous SEC enforcement actions, SRO proceedings and FINRA arbitrations, Howard also has the confidence to take a case to trial when necessary. Recently, he obtained victories in three significant matters, including prevailing in a price adjustment case involving the dispute of several hundred million dollars for a portfolio of real estate mortgages. He 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, leading prime brokers and clearance firms in regulatory and civil litigation. He is the author of the "Tipper and Tippee Liability" chapter in the *Insider Trading Law and Compliance Answer Book* published by the Practising Law Institute.

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, DC 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*, *Lawdragon* and *The Legal 500 United States* 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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Practices

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Real Estate Capital Markets & REITs

Joseph A. Smith

Joe represents private equity fund sponsors and institutional investors in connection with fund formation, the acquisition of portfolio investments and the implementation of exit strategies. In this capacity, Joe advises clients on securities, governance, ERISA, Investment Advisers Act and structural issues. He has extensive experience with all alternative asset classes, including venture capital and later-stage growth equity investments, leveraged buyouts, mezzanine investments, real estate ventures and opportunity funds, secondary investments, funds-of-funds and hedge funds. Joe has also represented many fund managers in connection with spin-offs and consolidations.

In addition to domestic representations, Joe has advised private equity clients in connection with the acquisition and structuring of portfolio company investments throughout Europe, Latin America and Asia. His representation of asset managers in the real estate sector includes advice concerning REIT offerings and privatizations, partnership roll-ups and cross-border investments. Joe's clients include Arcis Group, DRA Advisors, DuPont Capital Management, FirstMark Capital, GE Asset Management, Harbert Management Corporation, Hemisfério Sul Investimentos, Intel, Kotak Mahindra Group, The Praedium Group, Prosperitas Capital S.A., Ram Realty Services, REAL Infrastructure Partners, Royalton Partners, The Silverfern Group, Top Tier Capital Partners, Value4Capital, VCFA Group and Westport Capital Partners.

Joe has been recognized as a leading practitioner by *Chambers Global*, *Chambers USA*, *The Legal 500 United States* and *The Legal Media Group Guide to the World's Leading Private Equity Lawyers*. He recently discussed the "State of the Industry" at IMN's *European Real Estate Opportunity & Private Fund Investing Forum* and "Meeting Private Equity Real Estate Fundraising Challenges" at iGlobal Forum's *7th Real Estate Private Equity Summit*.

Joe received his J.D. from New York University School of Law and his A.B. from Columbia University.

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Practices

Litigation

Financial Institutions

Regulatory & Compliance

Securities Enforcement & White Collar Defense

Sung-Hee Suh

Sung-Hee 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/regulatory matters include representing a brokerage firm in SEC and CFTC investigations into a purported whistleblower complaint regarding certain swap trades; defending a foreign bank in a DOJ action seeking forfeiture of interbank accounts; conducting an internal investigation into possible insider trading by a former employee of a large investment firm; representing an interdealer brokerage firm in DOJ and CFTC investigations into the setting of LIBOR and other benchmark interest rates; 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; and conducting an internal investigation for a global telecommunications company into possible Foreign Corrupt Practices Act (FCPA) violations. Her recent work in civil cases includes representing Merck's former chief scientist in numerous Vioxx-related securities, products liability, ERISA and shareholder derivative actions throughout the country, and defending the former general partner of a private equity co-investment fund against claims for clawbacks of incentive fees.

A frequent speaker and writer, Sung-Hee 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 "Recent FCPA Developments Highlight Risk of Individual Liability" and "Government Launches FCPA Inquiry into Investments by Sovereign Wealth Funds in U.S. Banks and Private Equity Firms," both of which appeared in the *Financial Fraud Law Report*. She also speaks regularly at PLI's annual "Financial Services Industry Regulatory Compliance & Ethics Forum" and PLI's annual program on "Bet the Company Litigation."

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. The New York chapter of the National Organization for Women honored Sung-Hee with its annual Women of Power & Influence Award in 2011, and in 2012, *Benchmark Litigation* recognized her in its inaugural edition of the *Top 250 Women in Litigation*.

Sung-Hee 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. She received her A.B., *cum laude*, from Harvard/Radcliffe College and her A.M. from Harvard Graduate School of Arts and Sciences.

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Practices

Tax

Real Estate Capital Markets & REITs

Shlomo C. Twerski

Shlomo focuses 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. In addition, 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 addressed such topics as "FATCA and Dividend Equivalent Withholding Developments," "Tax Update 2012: FATCA and Other Issues" and "The Return of CLOs: Changes That Matter to Managers and Investors" 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*.

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Practices

Tax

Distressed Investing

Mergers & Acquisitions

Private Equity

Real Estate Capital Markets & REITs

Alan S. Waldenberg

Alan is chair of Schulte Roth & Zabel's Tax Group and also serves as Chair of the firm's Executive Committee. His practice focuses on income tax and international tax, including tax considerations in mergers and acquisitions, restructurings and workouts, with a particular emphasis on transactions involving investment funds. Representative engagements and transactions include serving as primary tax counsel for a group of investment funds in connection with: the acquisition of a majority of GMAC from General Motors and the subsequent restructuring of that investment, including GMAC's conversion to a bank and its receipt of an infusion of capital from the U.S. Treasury; the acquisition of a controlling interest in Chrysler from DaimlerChrysler; the sale of Chrysler Financial to TD Bank Group; and numerous other domestic and international private equity investments, including acquisitions of international banks, international finance companies, retail companies, manufacturing businesses and industrial operations. In addition, Alan has served as primary tax counsel in connection with the structuring of private equity funds and hedge funds, including funds investing primarily in domestic and international private equity, funds investing primarily in Asia and Europe, real estate funds, funds investing primarily in debt and distressed opportunity funds.

Alan is a member of the Taxation Sections of the American Bar Association and the New York State Bar Association, and is a Fellow of The New York Bar Foundation.

Alan earned his J.D., *cum laude*, from Harvard Law School and his B.A., *magna cum laude*, from the University of Maryland, after which he became a certified public accountant in the State of Maryland before attending law school.

Guest Speaker

Founder and CIO
Saba Capital Management, L.P.

Boaz Weinstein

Boaz Weinstein is the founder and CIO of Saba Capital Management, L.P. Boaz founded Saba in 2009 as a lift-out of the Deutsche Bank proprietary credit trading group he started in 1998. As of December 2012, the firm manages $5.4 billion, including approximately $500 million in its tail hedge strategy.

Previously, Boaz worked at Deutsche Bank for 11 years, the last eight as managing director (a title he received at age 27). In 2008, Boaz was promoted to co-head of Global Credit Trading, overseeing 650 investment professionals.

Boaz graduated from the University of Michigan with a B.A. in Philosophy.

Guest Speaker

Co-Chief Executive Officer
Reservoir Capital Group

Daniel H. Stern

Daniel H. Stern is founder and co-CEO of Reservoir Capital Group, a New York-based investment management firm.

Prior to founding Reservoir in 1998, Dan was president of Ziff Brothers Investments, a private investment advisory firm, and previously worked with the Burden Family in New York and the Bass Family in Fort Worth, Texas.

Dan has participated in the formation and development of numerous investment management entities, including Starwood Capital, Och-Ziff Capital Management, HBK Investments, Ellington Capital Management and Anchorage Capital, among others.

Dan is president of the Film Society of Lincoln Center. He is a trustee of Mt. Sinai Medical Center, the Educational Broadcasting Corporation (PBS Channel 13) and Lincoln Center for the Performing Arts.

Dan is a graduate of Harvard College and Harvard Business School.

Brian T. Daly

Harry S. Davis

Marc E. Elovitz

Steven J. Fredman

Howard Schiffman

Sung-Hee Suh

Regulatory Examinations and Enforcement

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Capital Raising in 2013

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US Managers Marketing in Europe: AIFM and Beyond

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Building an Investment Management Firm

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Building an Investment Management Firm

Notes:

Regulatory Examinations and Enforcement

I. Examination Insights

A. Recent developments in SEC examinations

1. The Office of Compliance Inspections and Examinations ("OCIE") supports the U.S. Securities and Exchange Commission's regulatory efforts by fielding examination teams in the Washington DC national office, as well as in SEC regional offices in Atlanta, Boston, Chicago, Denver, Fort Worth, Los Angeles, Miami, New York, Philadelphia, Salt Lake City and San Francisco.

2. OCIE undertook a comprehensive "self-assessment" in 2010 and has been seeking to implement changes and improvements in a variety of areas, including in strategy, structure, people, processes, training and technology.

3. The coordinated examination and inspection effort is termed the "National Examination Program" ("NEP") and it is applied to investment advisers, investment companies, broker-dealers, municipal securities dealers, transfer agents, clearing agencies, self-regulatory organizations ("SROs") and municipal advisers. OCIE has stated that the goals of the examinations conducted by the NEP staff are:

   (a) To improve compliance;

   (b) To prevent fraud;

   (c) To inform policy; and

   (d) To monitor firm and systemic risk.

4. The NEP staff has also set forth a series of "core principles" to help foster consistency across regions and specializations. These principles include:

   (a) Employing a risk-based approach, which is intended to improve and rationalize resource allocation based on a variety of sources and inputs (e.g., tips and complaints, analysis of aberrational performance, significant changes in registrants' business activities, and disclosures regarding regulatory and other actions brought); OCIE has established an Office of Risk Assessment and Surveillance to improve risk identification, assessment and monitoring.

   (b) Fostering a culture of teamwork and collaboration across offices and disciplines.

   (c) Setting higher standards and expectations for OCIE staff and seeking to hold staff accountable for achieving goals and objectives; this involves additional training (including an "SEC University") and a possible certification program.

   (d) Focusing on issues and allowing staff to "pursue the facts where they lead."

5. Coordination with other regulators: OCIE reported in early 2012 that it had "intensified coordination efforts with domestic and foreign regulators and the regulated community." As support for this proposition, OCIE cited a number of developments, including the following:

   (a) OCIE periodically holds national and regional summit meetings with SROs and state securities regulators.

   (b) OCIE sponsors training programs to which state securities regulators are invited and provides training directly to state regulatory personnel upon request.

   (c) OCIE staff in Washington and in the regional offices assist federal and state law enforcement agencies with criminal actions.

(d) NEP staff have conducted coordinated examinations with foreign regulators in the U.S. and abroad.

(e) OCIE has entered into or deepened a number of formal and informal cooperation or information-sharing arrangements with other regulatory bodies, including the Department of the Treasury, the Department of Labor, the Federal Reserve, the New York State Department of Banking, the National Association of Insurance Commissioners, and individual state insurance commissions.

B. Impact of the Dodd-Frank investment adviser registration requirement: the SEC has published a number of pieces of data that quantify some of the impact on the Commission (and, therefore, on the examination and inspection program) of the narrowing of the exemptions from SEC registration. The SEC has reported that, as of March 30, 2012.

1. There were nearly 4,000 registered investment advisers managing one or more private funds, of which approximately:

(a) Thirty-four percent registered following the effective date of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010;

(b) Thirty-two percent reported that they advised at least one private fund; and

(c) Seven percent were domiciled in a foreign country.

2. Registered advisers managed nearly 31,000 private funds with total assets of $8 trillion; and

3. Forty-eight of the world's 50 largest hedge fund advisers are registered with the SEC, as are 37 of the world's 50 largest private equity fund managers.

C. Presence examinations in the context of the overall national examination program

1. Background to the presence examinations: the NEP's overall response to the influx of new registrants is comprised of three elements (in addition to an ongoing evaluation of the new information now available to the SEC through Form PF submissions).

(a) An initial phase of industry outreach and education, in which the NEP seeks to share its substantive and procedural expectations of registrants and its perceptions of the highest risk areas. This phase began in 2012 and is continuing.

(b) A second phase characterized by a coordinated series of examinations of a "significant percentage" of new registrants. This phase is intended to focus on the highest risk areas of the newly registered advisers and to assist the NEP in "risk rating" them. These are the so-called "presence examinations" that are currently being conducted.

(i) The concept of the "presence examination" came into prominence with the October 2012 circulation by the SEC of a form "Dear Senior Executive" letter.[1] This letter was drafted to introduce the senior management of newly registered investment advisers (and the general investment adviser community) to the NEP and to inform them of the new presence examination initiative.

(ii) However, the concepts that underlie the presence examination announcement were being previewed by senior SEC staff members throughout 2012. For example, at the SEC's Jan. 31, 2012 "Compliance Outreach," a number of SEC officials discussed plans for strengthening the

[1] The October 2012 letter is available at http://www.sec.gov/about/offices/ocie/letter-presence-exams.pdf.

national examination program, with an emphasis on examining a significant percentage of the newly-registered advisers and using the knowledge learned through these examinations to improve and focus the overall examination process. By the spring of 2012, senior staffers were publicly explaining that the initiative would be divided into three stages and identifying many of the focus areas (all of which were described in detail in the October letter).

(c) A final phase marked by the publication of a series of "after action reports." These reports are expected to identify and treat broader issues, risks and themes identified by the SEC staff in the presence examinations.

2. Presence examinations as carried out by the NEP

(a) The presence examination initiative is intended to take place over two years and to conduct "focused, risk-based examinations" of investment advisers to private funds. The target universe comprises investment advisers that registered with the SEC after the definitional and transitional rules under the Dodd-Frank Act became effective (i.e., after July 21, 2011).

(b) The NEP has circulated a non-exclusive list of five areas that form the core of the presence examinations. Registered advisers should be on notice that examiners will focus on, and request books and records relating to, one or more of the following areas:

(i) Marketing, which could include a review of marketing materials to evaluate whether they contain false or misleading statements of material facts, omit material facts or are otherwise manipulative, fraudulent or deceptive;

(ii) Portfolio management, which could include a review of portfolio decision-making and trading practices, with a particular focus on the allocation of investment opportunities;

(iii) Conflicts of interest, which could include an inquiry into the controls and procedures in place to "identify, mitigate, and manage" conflicts of interest, including in areas such as the allocation of investment opportunities, fees and expenses, payments by private funds to an adviser or to its related persons, outside business activities and personal securities trading of adviser personnel, and transactions with affiliates of the adviser;

(iv) Safety of client assets, which could include an evaluation of compliance with the "custody rule" and related measures designed to prevent the loss or theft of client assets; and

(v) Valuation, which could include a review of valuation policies and procedures, especially for illiquid or difficult to value instruments, and the calculation of fees and expenses.

(c) Presence examinations are expected to have on-site and off-site components; the on-site portions are expected to be more focused and shorter than those of a standard examination.

(d) The SEC has stated that, at the conclusion of the presence examination, NEP staff may send a letter indicating that the examination has concluded without findings or may send a so-called "deficiency letter" that describes issues identified by the NEP staff and asks for corrective actions.

(i) As with all examinations, if serious deficiencies are found, the examination staff may refer the matter to the SEC's Division of Enforcement, to a self-regulatory organization, to a state regulatory agency or to another regulator.

D. "Sweep" examinations: issue-specific sweep examinations continue to be utilized by OCIE.

   1. In October 2012, for example, a senior SEC officer discussed the results of a two-year sweep examination initiative focused on conflicts of interests.

   2. Sweep examinations range in scope and in intrusiveness. Some advisers pulled into a sweep exam may merely have to provide documents responsive to a targeted request list; other managers may experience on-site interviews and multiple document requests.

E. "Standard" examinations

   1. OCIE continues to conduct standard (i.e., non-sweep and non-presence) investment adviser examinations. While presence examinations are a current priority for the next two years, advisers should be prepared for a standard examination as well as a presence examination during that period.

   2. The SEC has indicated that its personnel schedule standard examinations on the basis of a number of factors, which could include perceived risk, size and complexity, prior examination frequency and findings, and tips or referrals.

   3. OCIE has indicated that in the course of conducting examinations, NEP personnel will be focused on classic risk factors (e.g., asset protection, valuation, conflicts, marketing and performance issues and governance) as well as emerging risk factors (e.g., IT infrastructure, business continuity and crossovers between providing brokerage services and providing investment advice).

   4. Request lists and examination focuses are tailored by business types (e.g., private equity managers will not receive the same initial request list as hedge fund managers), reflecting a broadening of the adviser population as well as of the SEC's skill set.

   5. The SEC clearly believes that regular examinations are important to safeguarding market integrity, and cites as proof a number of successful enforcement actions that originated with an on-site examination.

II. SEC Enforcement Insights

A. Priorities in 2012 and going forward: in FY 2012 the SEC brought a total of 734 enforcement actions, continuing its recent trend of bringing a high volume of cases. The Commission collected $3.1 billion in disgorgement and fines during that period. The SEC has increased its focus on hedge funds and in general has continued to prioritize insider trading cases and those related to the financial crisis.

   1. Insider trading cases: the Commission initiated 58 cases in FY 2012.

   2. Hedge fund enforcement: the Commission brought 147 cases against hedge funds, hedge fund managers and other investment advisers in FY 2012.

   3. Financial crisis enforcement: the SEC continues to bring enforcement actions stemming from alleged misconduct occurring during the financial crisis.

      (a) The Commission brought 29 such cases in fiscal year 2012, which represents an increase over 2011.

      (b) Those cases primarily involve alleged misleading statements or omissions as to investment risk.

B. The Whistleblower Program is getting off the ground.

1. The Whistleblower Office has been staffing up and now has eight full-time attorneys in addition to a chief, deputy chief and support staff that includes a program support specialist.

2. In August 2012, the SEC made its first payout to a whistleblower under the new program initiated after Dodd-Frank.

   (a) The whistleblower provided a tip about an ongoing multimillion dollar fraud.

   (b) The whistleblower has been awarded 30 percent of the money recovered by the SEC.

3. In fiscal year 2012, the Office of the Whistleblower received 3,001 tips potentially eligible for a monetary award.

   (a) The most common tip received by the Office had to do with alleged corporate disclosure and financial statement violations.

   (b) The Office received over 450 tips related to alleged market manipulation and nearly 200 regarding alleged insider trading.

   (c) The SEC contends that since the program was implemented, the quality of the tips it has received has improved, leading to more effective enforcement initiatives.

C. New enforcement strategies: the SEC is supplementing its traditional examination and enforcement strategies with innovative new approaches, which have led (or are expected to lead) to some major enforcement actions.

1. New capabilities

   (a) Of particular relevance to hedge funds is the SEC's Aberrational Performance Inquiry, in which the Commission utilizes proprietary risk analytics to scrutinize hedge fund returns as compared to certain benchmarks, such as the funds' stated investment strategies.

      (i) The SEC brought three cases against investment advisers in FY 2012 as a result of discoveries made using this method, and criminal cases have followed as well. For details on those cases, see the discussions below of *SEC v. Yorkville Advisors* (section III(A)(2)), *SEC v. Kapur* (section III(D)(14)) and *SEC v. Balboa* (section III(A)(5)).

   (b) The SEC is also fielding new technological capabilities, such as an e-discovery system.

2. More expertise: the Commission also credits in part its hiring of industry experts and an enhanced training program for allowing it to bring more complicated cases against sophisticated institutional investors like hedge funds.

3. Specialization: the chairman credits the creation of specialized units with helping to detect misconduct that would otherwise have gone unnoticed. As an example, she cites an instance where the Asset Management Unit discovered a fraud after studying securities offerings on social media, and noticing unusual characteristics of one set of offerings.

III. Notable SEC Enforcement Actions Initiated in 2011 and 2012

A. Valuation cases

1. *SEC v. RKC Capital Mgmt., LLC*, No. 12-cv-408 (D. Utah April 30, 2012)

(a) Allegations: in this case, the SEC has brought suit against a hedge fund manager for allegedly artificially inflating the assets of a fund under its management. The fund was heavily invested in one particular penny stock, and the SEC alleges the defendants took steps to inflate the value of that stock by marking the close and placing matching orders. Further, the SEC alleges that the defendant used inflated prices of the stock in valuing the fund's portfolio at the times when its manipulative trading practices were ineffective.

(b) Status: the case is still pending, with no notable developments to date.

2. *SEC v. Yorkville Advisors, LLC*, No. 12-cv-7728 (S.D.N.Y. Oct. 17, 2012)

(a) Allegations: here, the SEC has brought suit against a hedge fund manager, claiming that the defendants have overvalued the assets under their management and made other false statements to investors. The defendant's investment strategy was largely based on providing equity financing to small companies. According to the SEC's allegations, the hedge funds were often paid in shares of those companies, which shares the defendants traded on the open market. The SEC alleges that in the lead-up to and during the financial crisis, the defendants overvalued assets connected to those equity finance transactions in violation of GAAP by relying on their face value rather than calculating their market value, and by factoring in what the SEC describes as interest and loan repayments they were not likely to recover. The defendants are also alleged to have made numerous misrepresentations to investors, including regarding their use of an independent valuator and regarding the funds' liquidity.

(b) Status: there have not been any notable developments in court since the case was filed.

(c) This is an example of a case brought pursuant to the Aberrational Performance Inquiry.

3. *SEC v. Commonwealth Advisors, Inc.*, No. 12-cv-700 (M.D. La. Nov. 8, 2012)

(a) Allegations: in this case the SEC alleges that an investment adviser to several hedge funds overvalued those funds by hiding mortgage-backed-securities-related losses sustained during the housing crisis. The SEC alleges that one of the ways in which the defendants sought to hide such losses was to sell those securities at inflated prices to a CDO they managed and played a role in forming, and effected that sale in part by trading those securities between managed hedge funds in violation of their compliance manual. Allegedly, the defendants made numerous valuation- and diversification-related misrepresentations to investors, engaged in a series of manipulative cross trades between funds under their management and provided an independent valuation company with false statements in order to skew its analysis.

(b) Status: the case is pending.

4. *In the Matter of Alderman*, No. 3-15127, Dec. 10, 2012

(a) Allegations: in this SEC administrative proceeding, the commission has targeted the former directors of several investment companies alleging valuation violations under the Investment Company Act. Particularly, the SEC alleges that at a time when market-values were not available, the directors delegated the responsibility for valuing high-risk debt securities, which comprised a majority of their portfolios, without providing appropriate guidance or oversight in ensuring that the fair values would be properly determined.

(b) Status: the case is pending.

5. *SEC v. Balboa*, No. 11-cv-8731 (S.D.N.Y. Dec. 1, 2011)

(a) Allegations: in this case, the SEC alleges that the defendants artificially inflated the value of a hedge fund, focused on emerging markets, under their management. Specifically, they are alleged to have reported false mark-to-market quotes to outside valuators in order to inflate their N.A.V. and recover higher fees than they were entitled. The SEC alleges that they overstated the value of the fund by $163 million.

(b) Status and criminal proceeding: the civil case has been stayed during the pendency of a criminal case arising from the same conduct.

(c) This is an example of a case brought pursuant to the Aberrational Performance Inquiry.

B. Track record cases

1. *In the Matter of GMB Capital Mgmt. LLC*, No 3-14854, Apr. 20, 2012

(a) Allegations: in order to attract new investors, the defendants falsified their track record, holding out certain figures as representing actual returns investment made pursuant to their quantitative investment model, when in fact the numbers reflected mere simulations. Further, the defendants falsely represented that certain funds were liquid, when in fact they were funds of funds, and mostly illiquid. In response to an SEC request for information, the defendants submitted false information as well.

(b) Status: in addition to several injunctions, the defendants were held jointly and severally liable for $4.3 million in disgorgement, and the individual defendants were fined $250,000 each.

2. *In the Matter of BTS Asset Mgmt., Inc.,* No. 3-15802, Oct. 29, 2012

(a) Allegations: in this case, the defendant, an investment adviser, claimed from 1990 to 2010 that its high-yield bond fund program had "no down years" since 1981, relative to a composite of similar funds. However, it had such a "down year" in 2004, and was aware of that fact, making its claims from 2005-2010 false.

(b) Status: the defendant was assessed a civil penalty of $200,000 for the violation.

C. Conflict of interest cases

1. *In the Matter of Martin Currie, Inc.,* No. 3-14873, May 10, 2012

(a) Allegations: this case is based on a manager's use of one fund to rescue another during the financial crisis to satisfy a redemption request. Essentially, the manager induced the rescuing fund to invest in an unfavorable bond deal to the benefit of the rescued fund, without disclosing to the former's board the conflict of interest involved and without following proper valuation procedures, thereby misrepresenting its value. This left the rescuing fund with significant losses.

(b) Status: the defendants were assessed an $8.3 million civil penalty. For the same conduct, the defendants were sanctioned by the FSA and required to pay £3.5 million.

2. *In the Matter of Centaur Mgmt. Co. LLC,* No. 3-14950, July 17, 2012

(a) Allegations: in this case, the defendant directed a client fund to give it $15 million in interest-free loans over a three-year period, which it used among other things to pay employee salaries. The defendant failed to disclose those loans to the investors.

(b) Status: although the loans were ultimately repaid in full, the defendant paid $172,000 in disgorgement for depriving the fund of the use of its assets, as well as a civil penalty of $150,000.

3. *In the Matter of Tilden Loucks & Woodnorth, LLC*, No. 3-15081, Oct. 29, 2012

   (a) Allegations: in this case, an investment adviser was realizing undisclosed compensation from artificially inflated commissions on trades made through a related broker-dealer (the co-defendant). Both defendants were wholly owned subsidiaries of a common company, creating a conflict of interest that was not disclosed to investors.

   (b) Status: they were ordered to pay disgorgement of the $170,000 in profit realized, plus fines of $100,000 each.

4. *In the Matter of Western Pacific Capital Mgmt.,* No. 3-14619, Nov. 10, 2011

   (a) Allegations: the case involved an investment adviser that was also the "placement agent" for a stock offering, entitling it to placement fees. It advised its clients to invest directly in the offering and in a hedge fund without disclosing that conflict of interest or that the fund was invested primarily in that one stock, earning almost $500,000 in placement fees. The defendant also improperly used the fund to buy out a client who did not want to own stock in the company any more. The defendant also made significant misrepresentations regarding the fund's liquidity.

   (b) Status: the defendant was ordered to disgorge the illicit profit and pay a civil fine of $130,000.

5. *In the Matter of Focus Point Solutions, Inc.,* No. 3-15011, Sept. 6, 2012

   (a) Allegations: in this case, the defendants, investment advisers sharing common ownership, failed to disclose three separate conflicts of interest to its client. One of those conflicts of interest involved an arrangement with a broker-dealer that incentivized Focus Point to direct clients to certain mutual funds. In another, Focus Point provided misleading information regarding its fee structure to the board of trustees for a fund for which it sought sub-adviser status. Further, one of the advisers voted for the other for that sub-adviser appointment, in the advancement of its own interests, rather than its clients'.

   (b) Status: Focus Point was ordered to pay disgorgement of $900,000 and $100,000 in penalties for the violations. The other entity and the individual defendant each paid $50,000 fines.

6. *SEC v. Harbinger Capital Partners LLC*, No. 12-cv-5027 (S.D.N.Y. June 6, 2012)

   (a) Allegations: here, the SEC has filed suit against a hedge fund manager for allegedly misappropriating over $113 million of fund assets to himself in the form of a low-interest loan to pay personal tax obligations, at a time when investors were not able to redeem their interests. In order to procure the loan, the defendant allegedly provided outside counsel with false or misleading information regarding, among other things, the fund's liquidity and the need for the loan. After obtaining the loan, the SEC alleges that the defendant failed to disclose it to investors for a period of five months, and then made misleading statements to current and prospective investors regarding the nature of the loan and the consultations with outside counsel. The SEC additionally alleges that the defendant secured redemption restrictions improperly, in part by entering into side deals with institutional investors and hiding these deals from the fund's board.

   (b) Status: motions to dismiss the case are pending before the court.

7. *SEC v. Aletheia Research and Mgmt., Inc.*, No. 12-cv-10692 (C.D. Cal. Dec. 14, 2012)

   (a) Allegations: in this case, a hedge fund adviser that is now in bankruptcy is alleged to have engaged in a cherry-picking scheme, whereby it allocated winning trades to certain accounts and losing trades to two hedge funds. The SEC alleges that under that scheme, the favored accounts gained over $4 million in profit and the two hedge funds suffered about $4.4 million in losses. The SEC additionally alleges that the defendant failed to timely disclose its dire financial condition to investors.

   (b) Status: the case is pending.

D. Disclosure Cases

1. *In the Matter of AXA Rosenberg Group,* No, 3014224, Feb. 3, 2011

   (a) Allegations: here, a money manager hid an error in its computer code related to risk management, causing about $217 million in losses. The company instructed the employee who discovered the error to keep it to himself, and only disclosed it to the SEC and then investors when informed of an impending investigation.

   (b) Status: the company was ordered to pay restitution to its clients, institute compliance procedures, and pay a civil penalty of $25 million.

2. *In the Matter of Envision Capital Mgmt., Ltd*. No. 3-14260, Feb. 16, 2011

   (a) Allegations: in this case, a hedge fund manager made inaccurate and incomplete disclosures regarding the values of various real estate loans in the funds' portfolios. The manager also improperly paid one fund's property expenses with cash from another fund. These violations were committed in violation of the company's own compliance procedures.

   (b) Status: the SEC ordered the defendant to improve its compliance, and to pay a fine of $100,000.

3. *In the Matter of Aletheia Research & Mgmt., Inc.,* No.3-14374, May 9, 2011

   (a) Allegations: in this case, the defendant failed to disclose information about an SEC examination to its clients and prospective investors and failed to follow certain procedural requirements regarding compliance, such as implementing written procedures and performing an annual surprise examination of its hedge funds.

   (b) Status: the company paid a $200,000 civil penalty, and the individual defendants paid penalties of $100,000 each.

4. *In the Matter of Quantek Asset Mgmt., LLC*, No. 3-14893, May 29, 2012

   (a) Allegations: here, the defendants made several material misrepresentations in side letters and due diligence reports. They represented that they had skin in the game when they did not, they misrepresented their investment approval process and they made misrepresentations regarding certain related party transactions. In particular, they failed to vet investments through their investment committee at least in part because of their rapid growth and disorganization. Also, Quantek made loans to related parties, but made misrepresentations to its investors about those loans.

   (b) Status: defendants were ordered to pay disgorgement of over $2 million, and the SEC assessed several smaller fines for various individual defendants.

5. *In the Matter of Pegasus Investment Mgmt., LLC,* No. 3-14425, June 15, 2011

   (a) Allegations: in this case, a hedge fund manager received $90,000 in cash payments from a trading firm in return for allowing the firm to combine the fund's trades with the firm's through a common broker, resulting in lower commission fees. The manager failed to disclose that benefit to the investors. The SEC made an inquiry into the payments, leading to the action.

   (b) Status: they were ordered to disgorge the $90,000 and pay fines of $100,000 each.

6. *In the Matter of Consultiva Internacional, Inc.,* No. 3-14973, Aug. 3, 2012

   (a) Allegations: this case addresses an investment adviser's failure to adopt written compliance procedures. In an SEC examination in 2005, deficiencies were discovered regarding the defendant's maintenance of a compliance manual, and in a follow-up examination five years later the SEC found that insufficient corrective steps were taken and discovered new problems, such as the failure to perform an annual review of the compliance program.

   (b) Status: defendant was ordered to pay a civil penalty of $35,000.

7. *In the Matter of Evens Barthelemy,* No. 3-15012, Nov. 20, 2012

   (a) Allegations: the case deals primarily with compliance violations. Particularly, the defendant's compliance procedures were deficient in numerous respects, such as failing to make reference to the Advisers Act or to a fiduciary duty to clients in the compliance manual and failing to perform annual reviews. Further, the defendant misstated its AUM in order to meet the registration threshold of $25 million by moving the decimal point over one spot for each client in response to an SEC inquiry.

   (b) Status: the defendant did not receive a fine, but was barred from acting as an investment adviser for a period of two years.

8. *SEC v. Greenberg*, No. 11-cv-313 (D. Col. Feb. 7, 2011)

   (a) Allegations: In this case, the SEC brought suit against a hedge fund manager for numerous violations, including the negligent misrepresentation of the funds' safety, suitability, and diversification. The funds under the defendant's management suffered heavy losses due to the financial crisis and investments in Bernie Madoff's ponzi scheme, and in some cases retirees with conservative investment goals lost all of their savings. After an examination in 2006, the defendant had bolstered his compliance procedures, but they were still inadequate. Additionally, he inadequately disclosed his fee structure to his clients, and used hedge fund assets to pay a portion of the rent for his apartment, which he did eventually reimburse.

   (b) Status: the action terminated by consent judgment, and the defendant was ordered to pay $4.3 million in disgorgement, but that figure was reduced because of his financial condition.

9. S*EC v. Ficeto*, No. 11-cv- 1637 (C.D. Cal. Feb. 24, 2011)

   (a) Allegations: in this case, a broker-dealer and hedge fund management company are alleged to have manipulated the market for microcap stocks, allowing defendants to overstate the value of their funds under management, among other things. The SEC alleges that the defendants used fund assets to drive up prices for such stocks by placing matching orders for them, marking the close, and engaging in wash sales, allowing the defendants to realize $63.7 million in gains.

(b) Status: the case remains pending after the court denied a motion to dismiss by the London-based hedge fund manager, which claimed that 10b cannot apply extraterritorially.

10. *SEC v. Juno Motion Earth Asset Mgmt., LLC*, No. 11-cv-1778 (S.D.N.Y. Mar. 15, 2011)

(a) Allegations: this case involves numerous misrepresenations by hedge fund managers to their investors. For example, the defendants withdrew money from the fund they managed to pay their expenses, despite representations to investors that they wouldn't use funds for such purposes. The managers also withdrew $1.7 million from the fund in exchange for notes, without disclosing this to either the investors, directors or the administrators of the fund. The defendants also made affirmative misrepresentations about the value of the fund and falsely claimed they had skin in the game.

(b) Status: all of the defendants have consented to judgment of liability, but the matter remains open to determine the issues of fines and disgorgement.

11. *SEC v. Gruss*, No. 11-cv-2420 (S.D.N.Y. Apr. 8, 2011)

(a) Allegations: in this case, the SEC alleges that the CFO of an investment adviser violated the Advisers Act by making several improper fund transfers between funds that were repaid but did not include loan documentation, by early withdrawal of management fees, and by using funds to assist in the purchase of a private plane for the company's chairman.

(b) Status: the case remains pending after a motion to dismiss challenging the action as an improper extraterritorial application of section 206 was denied, as was a motion for interlocutory appeal on that issue.

12. *SEC v. Marks*, No. 12-cv-4486 (N.D. Cal. Aug. 2, 2012)

(a) Allegations: here, the SEC sued the manager of numerous hedge funds for negligent misrepresentations and lack of disclosures. Specifically, the defendant misled investors by indicating that the various funds (which were funds of funds) were not correlated with each other, creating a false picture of diversification. In truth, there was a strong correlation, and the defendant had failed to perform a correlation analysis. Further, the defendant inadequately informed investors as to the liquidity of the funds.

(b) Status: the case was resolved by consent judgment, with the defendant being ordered to pay $322,000 in disgorgement and a fine of $100,000.

13. *SEC v. Alleca*, No. 12-cv-3261 (N.D. Ga. Sept. 18, 2012)

(a) Allegations: this case involves an investment adviser who formed a private fund, which he held out as being a fund of funds, but which in truth was involved in active securities trading. The fund lost a lot of money, and the defendant tried to cover up the losses by opening new funds, making some payments to investors in the original fund with the assets in the new fund in a Ponzi-scheme manner.

(b) Status: the case remains open, but the defendant has consented to judgment, and his assets have been frozen.

14. *SEC v. Kapur*, No. 11-cv-8094 (S.D.N.Y. Nov. 10, 2011)

(a) Allegations: this case involves numerous misrepresentations by an unregistered hedge fund adviser managing several funds. The misrepresentations include overstating AUM, falsifying performance statistics, lying about its due diligence procedures for investments (the lack of which caused the funds to make investments in ventures that ultimately proved to be Ponzi schemes), and lying about the company's personnel.

(b) Status: although the court has entered judgments by consent against both defendants (the adviser and his company), the question of disgorgement remains pending.

(c) Criminal proceedings: the principal has been indicted for this conduct and the criminal case is pending.

(d) This is an example of a case brought pursuant to the Aberrational Performance Inquiry.

15. *SEC v. Barriger*, No. 11-cv-3250 (S.D.N.Y. May 13, 2011)

(a) Allegations: in this case, the manager of some real estate funds made material mistatements to his investors regarding their safety and liquidity, misrepresenting them as conservative and successful investments when in reality they were plummetting in value during the housing crisis. As part of his management of the funds, the defendant paid unjustified returns to some preferred investors and also injected cash from one fund to another without disclosing that fact to his investors.

(b) Status: the court entered judgment by consent and ordered the defendant to disgorge his profits.

(c) Criminal proceedings: there is a pending criminal case arising out of the same conduct.

E. Rule 105 Cases

1. *In the Matter of Horseman Capital Mgmt., L.P.,* No. 3-14202, Jan. 24, 2011

(a) Allegations: in this case, an FSA-registered investment manager with four funds short sold Merrill Lynch stock within the restricted period for a gain of $1.3 million. After learning of its violation it voluntarily instituted policies and procedures to prevent a recurrence.

(b) Status: the defendant was ordered to pay disgorgement and a $65,000 fine.

2. *In the Matter of Aristeia Capital, LLC,* No. 3-14360, May 2, 2011

(a) Allegations: in this case, an investment adviser with two groups of hedge funds under management sold short within the restricted period on four different occasions within a five-month span, netting $1.2 million.

(b) Status: the defendant was ordered to pay a $400,000 penalty in addition to disgorgement.

3. *In the Matter of Harbinger Capital Partners, LLC,* No. 3-14928, June 27, 2012

(a) Allegations: In this case, an investment adviser and hedge fund manager, which had no Rule 105 training or procedures in place, committed three violations in a three-month span for a profit of about $858,000. In response to an SEC inquiry, it self-reported two of those violations. After learning of its violations, the defendant voluntarily instituted training and procedures for 105 compliance.

(b) Status: the defendant was ordered to disgorge its profits and pay a civil fine of $429,000.

4. *In the Matter of Brookside Capital LLC,* 3-14444, June 28, 2011

(a) Allegations: here, a hedge fund adviser changed its investment strategy with regard to a particular stock, causing it to buy shares within the restricted period after having sold it short a few days prior, resulting in $1.7 million in profits. The defendant undertook voluntary remedial efforts by adopting Rule 105 compliance procedures.

(b) Status: the defendant was required to disgorge its profits and pay a fine of $375,000.

5. *In the Matter of Level Global Investors, L.P.,* No. 3-14443, June 28, 2011

   (a) Allegations: in this case, a hedge fund adviser violated Rule 105 on two separate occasions in the spring of 2009, realizing a profit of $2.7 million. At the time of the violations, there were no written policies or procedures in place to detect or prevent such violations; and before the SEC investigation the defendant voluntarily set out to rectify that deficiency.

   (b) Status: in addition to disgorgement, the SEC ordered a civil fine of $375,000.

6. *In the Matter of Fontana Capital, LLC*, No. 3-14176, July 8, 2011

   (a) Allegations: this case involves a hedge fund adviser's three separate violations of Rule 105, resulting in $816,000 in profit.

   (b) Status: in addition to disgorgement, the defendant was ordered to pay a fine of $165,000.

7. *In the Matter of Wesley Capital Mgmt., LLC,* No. 3-14962, July 26, 2012

   (a) Allegations: in this case, a hedge fund manager violated Section 105 on two separate occasions in April of 2009, earning $142,000 in profit thereby. After learning of its violations, the defendant developed compliance policies to prevent recurrence.

   (b) Status: the SEC levied a $75,000 fine in addition to ordering disgorgement.

8. *In the Matter of JCSD Capital, LLC,* No. 3-15044, Sept. 24, 2012

   (a) Allegations: in this case, an investment adviser violated Rule 105 on one occasion in 2010, realizing about $60,000 in earnings as a result. It had no applicable compliance policies in place at the time, but developed them thereafter.

   (b) Status: the defendant did not receive a fine from the SEC, paying only disgorgement.

9. *In the Matter of Touradji Capital Mgmt., L.P.,* No. 3-14658, Dec. 9, 2011

   (a) Allegations: in this case, an investment adviser and hedge fund manager committed three Rule 105 violations, for a profit of $834,000. Although it had some training in place, it did not have policies or procedures in place to prevent or detect a violation.

   (b) Status: the defendant received a civil penalty of $350,000 in addition to being ordered to disgorge its profits.

IV. DOJ's and SEC's Insider Trading Enforcement

A. The Department of Justice has been aggressively investigating and criminally prosecuting insider trading cases, including through the use of investigative techniques that were historically associated with organized crime and narcotics kingpins, such as wiretaps and cooperating witnesses. This recent development is best illustrated by the Galleon and Primary Global-related prosecutions, but the trend is continuing. Many of the insider trading enforcement actions that are summarized below were largely the result of investigations in which the DOJ took the lead, with the SEC bringing its charges after or alongside the federal criminal charges.

1. *SEC v. Feinblatt*, No. 11-cv-170 (S.D.N.Y. Jan. 10, 2011)

    (a) Allegations: this case, which is related to the Galleon investigation, involved a pattern of insider trades by a hedge fund manager. Feinblatt, the manager, repeatedly traded on information he received from an individual investor, who also tipped Rajaratnam off to the same info. The tipster received his information from various sources. He learned about Polycom earnings results ahead of their public disclosure by an employee, and he learned of a Google earnings result ahead of its disclosure from an investment relations consultant to the company. Additionally, the tipster heard about the Blackstone Group's plans to takeover Hilton, and Hellman and Friedman's impending takeover of Kronos, from a Moody's analyst.

    (b) Status: the case was resolved by consent judgment as to all defendants. As part of the judgment against him, Feinblatt was ordered to pay $2.7 million in disgorgement.

2. *SEC v. Adondakis (Diamonback & Level Global),* No. 12-cv-409 (S.D.N.Y. Jan. 18, 2012)

    (a) Allegations: this case involves a network of hedge-fund personnel allegedly sharing and trading on nonpublic information regarding Dell and Nvidia. The SEC alleges that one defendant, an analyst at an investment adviser, repeatedly received information from an insider at Dell regarding the company's earnings and passed that information to some other defendants, who in turn shared it with others. The Commission alleges that the network operated in much the same way with regard to Nvidia's earnings, but the complaint does not specify where the information allegedly originated.

    (b) Status: the case remains pending, but judgment has been entered by consent against Diamondback, which was ordered to pay $5 million in disgorgement and a civil penalty of $3 million.

    (c) Criminal proceedings: while many defendants pleaded guilty, Newman (former porfolio manager at Diamondback) and Chiasson (co-founder of Level Global) were recently found guilty by a jury, and have not been sentenced as of this writing.

3. *SEC v. Longoria (Primary Global)*, No. 11-cv-753 (S.D.N.Y. Feb. 8, 2011)

    (a) Allegations: in this "expert network" case, the defendants were company insiders, investors and fund managers who repeatedly exchanged and traded on nonpublic information regarding sales, earnings and other performance metrics of several companies, including Apple, Dell and RIM. The investors received that information, directly or indirectly, from Primary Global Research (PGR) by way of technology employees at those companies, who were also paid PGR consultants.

    (b) Status: the civil action is closed, as all of the defendants have consented to judgment against them, with disgorgement orders ranging from $50,000 to, in the case of one investment adviser (Barai), $3 million.

    (c) Criminal proceedings: there are a handful of criminal actions arising out of this conduct, and the investment/hedge fund managers have pleaded guilty.

4. *SEC v. Whitman*, No. 12-cv-1055 (S.D.N.Y. Feb. 10, 2012)

    (a) Allegations: this case also relates to the Galleon investigation. In it, hedge fund manager Douglas Whitman allegedly traded on nonpublic information he received regarding earnings estimates at Polycom and Google from his neighbor, the tipster for Rajaratnam and in *Feinblatt* (above). Whitman allegedly realized almost $1 million in gains for his fund as a result of this trading.

(b) Status: the civil case remains pending.

(c) Criminal proceedings: Whitman has been convicted by a jury of criminal charges related to this conduct.

5. *SEC v. Skowron*, No. 10-cv-8266 (S.D.N.Y. Apr. 13, 2011)

(a) Allegations: in this case, a hedge fund manager received repeated updates of nonpublic information regarding the ongoing clinical trial of a company's drug from a doctor involved in those trials, who the manager had connected with via an expert networks firm. The manager traded approximately six million shares of stock on behalf of six hedge funds on the basis of that information, and the funds avoided about $30 million in losses as a result.

(b) Status: the civil case has been resolved by consent against all parties, with the funds — which were joined as relief defendants — liable to disgorge the $30 million.

(c) Criminal proceedings: the manager pleaded guilty to criminal charges and was sentenced to 60 months imprisonment and a $150,000 fine, while the insider pleaded guilty and was sentenced to three years and $6 million in restitution.

6. *SEC v. Siris*, No. 12-cv-5811 (S.D.N.Y. July 30, 2012)

(a) Allegations: here, the SEC brought suit against an investment adviser, his IM firm, and his consulting company for a wide range of misconduct in connection with the adviser's ties to Chinese companies. In addition to numerous other charges, the SEC alleged that he sold shares in one such company after receiving, in his capacity as its consultant, nonpublic information regarding illegal activities at the company and the shuttering of one of its factories. Additionally, the defendant traded, primarily in the form of short selling, ahead of 10 confidential Chinese offerings, after being brought over the wall in regard to those offerings by underwriters, placement agents, and broker-dealers.

(b) Status: the case has been resolved by consent judgment for disgorgement of $1.2 million.

7. *SEC v. Clayton Peterson*, No. 11-cv-5448 (S.D.N.Y. Oct. 21, 2011)

(a) Allegations: in this case, a board member at Mariner Energy repeatedly tipped off his son, an investment adviser, about an impending acquisition of Mariner. The son bought stock for himself and others, and also informed his friend, a hedge fund manager, about the acquisition. The hedge fund manager traded on that information on behalf of the fund for a profit of $5 million.

(b) Status: all defendants consented to judgment, and the hedge fund manager and the funds were held jointly and severally liable for the $5 million.

(c) Criminal proceedings: the hedge fund manager pleaded guilty to criminal charges and received a one-year sentence.

8. S*EC v. Clay Capital Mgmt.*, No. 11-cv-5020 (D. N.J. Aug. 31, 2011)

(a) Allegations: in this case, a hedge fund manager received nonpublic information from his brother in law, then an employee at Autodesk Inc., regarding the impending acquisition of Moldflow Corporation by Autodesk. He also received information regarding Autodesk's financial results. The manager traded on that information on behalf of himself, others, and his fund. He also passed the information to an acquiantence, who also traded on the information. Subsequently, the acquaintence, then an employee of Salesforce.com, tipped the hedge fund manager off regarding his company's earnings, and the defendants trading on that information as well.

(b) Status: the defendants consented to judgment, and the hedge fund manager and his company were ordered to disgorge their $3.9 million in illicit profits.

(c) Criminal proceedings: after guilty pleas in a related criminal case, the insiders received probation and the hedge fund manager received a 12-month sentence.

9. *SEC v. CR Intrinsic*, No. 12-cv-8466 (S.D.N.Y. Nov. 21, 2012)

(a) Allegatations: in this case, a hedge fund manager is alleged to have had numerous interactions — through an expert network firm — with the doctor overseeing the clinical trials of an Alzheimer's drug developed by Elan and Wyeth. The SEC alleges that the trades the manager executed in response to nonpublic information received from the doctor yielded $276 million in illicit gains, making this the largest insider trading case ever brought by the SEC.

(b) Status: the case is pending, but the insider has already consented to judgment, and has been ordered to disgorge his $187,000 gains.

(c) Criminal proceeding: the U.S. attorney has brought criminal charges against the hedge fund adviser.

10. *SEC v. Tiger Asia Mgmt, LLC*, No. 12-cv-7601 (D.N.J. Dec. 12, 2012)

(a) Allegations: in this case, the SEC charged a hedge fund manager and his head trader with insider trading in Chinese bank stocks. The defendants were alleged to have shorted those stocks after receiving information about private placements of them and despite entering into wall-crossing agreements with regard to those placements. The SEC additionally alleged that the defendants engaged in a manipulation scheme, in order to collect higher management fees, by using fund assets to place losing trades on stocks it held short.

(b) Status: Immediately after the case was filed, the defendants consented to judgment against them. They were ordered to pay a total of approximately $44 million in civil penalties.

(c) Criminal proceedings: Contemporaneously with the civil case, Tiger Asia Management was criminally charged and pleaded guilty. It was ordered to pay $16 million in forfeiture and sentenced to probation.

V. CFTC Development and Enforcement Actions

A. Developments: the CFTC has been stepping up its enforcement activity in recent years. It brought 99 cases in FY 2011 and 102 cases in FY 2012, both records. It collected over $900 million in sanctions in FY2012.

B. Notable cases

1. *In the Matter of Benjamin Hutchen*, CFTC Docket No. 13-07, filed Nov. 27, 2012

(a) Allegations: in this case, the defendant, an associated person of Morgan Stanley, was found to have engaged in "fictitious sales" within the meaning of Section 4c(a) of the Commodity Exchange Act and Regulation 1.38(a) because he engaged in off-exchange trades in currency futures that were not backed by cash or over-the-counter derivatives. This caused non-bona fide prices to be reported to the Chicago Mercantile Exchange and the Chicago Board of Trade.

(b) Status: the defendant was ordered to pay a fine of $300,000 for his violations.

2. *In the Matter of Christopher Louis Pia*, CFTC Docket No. 11-17, filed July 25, 2011

   (a) Allegations: the defendant, a portfolio manager at a registered investment adviser was found to have artificially inflated the price of palladium and platinum futures by repeatedly marking the close on those contracts, trading heavily during the two-minute closing period for them. He engaged in this conduct for a period of months.

   (b) Status: in addition to being subject to a fine of $1 million, the defendant was permanently banned from trading in palladium and platinum and from trading in anything regulated by the CFTC during the closing period.

3. *CFTC v. Welsh*, No. 12-cv-1873 (S.D.N.Y. March 14, 2012)

   (a) Allegations: this federal court case arises out of the same underlying scheme in *Pia*, above. The defendant, an associated person with M.F. Global, is charged with assisting Pia in his market manipulation scheme. The defendant in this case allegedly placed Pia's orders for palladium and platinum, waiting until the final seconds of the closing period in order to drive up the price. The defendant is charged with aiding and abetting Pia's violations and as a primary violator himself.

   (b) Status: the case remains pending.

4. *CFTC v. Singhal*, No. 12-cv-138 (N.D. Ill. Jan. 9, 2012)

   (a) Allegations: in this case, the defendants (a mother-and-son team, where in truth the son did all the work, simply setting up one of the accounts in question in his mother's name) traded currency options between two accounts, appearing to participate in the market, but without doing so on a legitimate basis.

   (b) Status: the son was ordered to pay a civil penalty of $140,000 and disgorgement of $119,000 for his ill-gotten gains.

5. *CFTC v. Highland Stone Capital Mgmt., L.L.C.,* No. 11-cv-5209 (S.D.N.Y July 27, 2011)

   (a) Allegations: this case involves investment advisers allegedly soliciting investors to invest in foreign exchange accounts by misrepresenting those accounts' profits, falsifying account statements, and by making false assurances to investors as to how the accounts minimized risk. The CFTC claims that the defendants have violated the fraud provisions of the CEA. Further, the CFTC alleges that the defendants have committed registration requirement violations for failing to register as commodities trading advisers pursuant to Dodd-Frank.

   (b) Status: the case is pending, and the CFTC has moved for summary judgment.

6. *CFTC v. Moncada*, No. 12-cv- 8791 (S.D.N.Y. Dec. 4, 2012)

   (a) Allegations: here, a trader and two related entities for whom he worked have been charged with the attempted manipulation of wheat futures. The CFTC alleges that the defendants attempted to drive up the price of the December 2009 wheat futures contract through a course of conduct in October of that year intended to misrepresent the liquidity of the market. That purpose was allegedly effected by placing and immediately cancelling numerous orders, as well as by engaging in fictituous sales. The defendants are alleged to have placed "small dot" orders on the other side of their manipulative ones, in order to cash in on the scheme.

   (b) Status: the case is pending.

Capital Raising in 2013

I. Trends in Hedge Fund Capital Raising

A. Hedge funds experiencing inflows

1. Hedge fund capital increased by 3.6 percent as of the end of 3Q 2012 to a record level of $2.2 trillion.

2. Assets invested with hedge funds globally are expected to rise as a result of institutional investors increasing allocations to alternative investment managers.

B. Institutional investors continue to represent a growing component of hedge fund AUM while high-net-worth individuals and family offices continue to represent a shrinking component.

1. Between 2007 and 2011, high-net-worth individuals' and family offices' share of total hedge fund AUM fell from approximately 57 percent to approximately 40 percent.

2. A recent industry survey predicts that institutional investors will increase the percentage of their portfolios allocated to hedge funds from 4.5 percent to six percent.

3. Many institutional investors are managing their own fund investments and are investing directly in trading funds.

4. As of 3Q 2012, the number of funds of funds declined to a level not seen since 2005. Fund of funds managers are continually being asked to provide (and are offering) unbundled services (e.g., due diligence, non-discretionary recommendations).

5. An increase in the importance and number of institutional investors has resulted in an increase in the negotiation of hedge fund terms.

   (a) Forty-three percent of participants in an industry survey of institutional investors conducted in 2012 experienced a change in fund terms in favor of the investor, up from the 30 percent that experienced such a shift in a similar study conducted in 2011.

6. As hedge funds accept more capital from institutional investors, more managers are running their funds as "plan assets" for purposes of ERISA or "hard-wiring" their funds to help avoid plan asset implications.

C. Institutional investors continue to favor large managers because of their past performance, institutional-quality infrastructure and reputation.

II. Structuring/Terms

A. Fees

1. There is continuing pressure on the 2/20 fee structure, with more pressure to lower management fees than incentive compensation. The mean management fee for single-manager hedge funds was 1.60 percent as of September 2012, a 20 percent decrease from the traditional two percent management fee.

2. Twenty percent remains the standard rate for incentive compensation, although lower rates are being offered in founders classes and as part of tiered fee structures, and some managers have agreed to hurdles.

3. Some managers have introduced the concept of "tiered" incentive compensation, where the rate of the incentive compensation is based on the performance of the fund (e.g., 10 percent incentive allocation on the net appreciation until the investor

has achieved a 10 percent return, 20 percent incentive allocation on the net appreciation between a 10 percent return and 20 percent return and 25 percent on the net appreciation in excess of a 20 percent return).

4. Although there had been discussion of multi-year incentive compensation and clawback arrangements over the last several years, there have not been a substantial number of funds that have launched with those arrangements.

B. Founder classes

1. Founder classes are increasingly offered to induce early-stage investment in new funds and may be seen as an alternative to seed capital.

2. Founder classes generally give investors reduced fees in exchange for assuming the risks of investing in a new fund and, in some cases, being subject to a lock-up period or longer lock-up period.

3. Reduced fees typically apply to subscriptions made prior to a certain date following fund launch or prior to a fund reaching a certain level of assets.

4. Reduced fee terms vary but most commonly offer a 25- to 50-basis point reduction on management fees and a 2.5 percent to five percent reduction on performance compensation.

5. There is typically no minimum subscription amount for an investor to access founder classes, other than any minimum subscription amounts established by the fund for all investors.

C. Expense caps

1. Another enticement offered to induce early-stage investment in new funds is a cap on expenses. Expense caps are broken down into two types: (i) caps on organizational expenses; and (ii) caps on operating expenses.

   (a) Similar to private equity funds, the size of the cap on organizational expenses typically depends on the size of the initial fundraise.

   (b) Caps on operating expenses typically are limited to ordinary operational and administrative expenses that are not investment related and exclude taxes, management fees, incentive compensation and extraordinary expenses (e.g., indemnification expenses). The expenses subject to a cap often include: (i) legal; (ii) accounting; (iii) auditing; (iv) consulting; and (v) administrative.

   (c) Operating expense caps may be limited in time or expire when the fund reaches a certain size. Managers have structured expense caps so that: (i) the manager is reimbursed for expenses it has paid to the extent the fund is under the cap in future years; and/or (ii) the fund carries forward unused expense cap to future years.

   (d) Some managers have voluntarily agreed to bear certain fund expenses until the fund reaches a certain size.

   (e) Expense caps that expire and voluntary payment of fund expenses by the manager may create disclosure obligations with respect to fund performance. The manager should include disclosure in its marketing materials stating that the fund's performance reflects higher returns than those that would have been earned if no cap or expense payment arrangement was in place and the difference in the expense ratio.

D. First-loss capital

1. A few managers and sponsors have offered first-loss capital products as an alternative to standard hedge fund terms.

2. In a first-loss capital arrangement, the sponsor raises assets for an account in which the hedge fund manager that has investment discretion for the account also makes a capital contribution. Losses from trading in the account are first allocated to the manager's capital account. In return, the manager typically receives above-standard performance fees on appreciation in the account.

3. To the extent a first-loss capital product is being managed side-by-side with other accounts advised by the manager, conflicts of interest need to be addressed by the manager related to the higher fee structure and the fact that the manager's proprietary assets are at risk in a first-loss scenario.

E. Liquidity/side pockets

1. Funds launching with the ability to create side pockets and older funds retaining their ability to create side pockets are increasingly rare. Managers instead have been setting up discrete special opportunities vehicles to pursue illiquid opportunities.

2. For new funds, lock-up periods and lock-up periods of more than one year are less common, especially where the fund has a liquid investment program.

3. New funds frequently have investor-level gates instead of fund level gates. which provide managers with a more stable asset base and have a high level of investor acceptance.

F. Corporate governance

1. Investors specifically look for independent directors. A few managers are utilizing independent boards in the partnership context with the power to review or make certain decisions (e.g., review of suspension of redemptions, related-party transactions, distributions in kind, valuation procedures).

2. Incestors and managers are paying more attention to the qualifications of directors, including professional backgrounds, the amount of time spent on fund governance and the number of funds for which a person serves as a director.

3. Some funds utilize independent directors from multiple director service providers to increase independence.

G. Side letters

1. The increase in institutional investors has led to an increase in requests for side letters (with a focus on transparency, reporting and notice/redemption rights upon certain events involving the fund and the manager).

2. Some managers attempt to abide by a policy of not entering into side letters granting preferential terms, and a few established managers have attempted to eliminate existing side letters by incorporating the terms into the fund's governing documents for the benefit of all investors.

H. "Mega" managed accounts

1. The "mega" managed account typically involves a single discretionary investment account formed by a large investment manager to invest assets for an institutional investor (e.g., a state plan or sovereign wealth fund) across the manager's multiple business lines (hedge, private equity, real estate, venture capital, etc.).

2. Generally avoids investment committee approval by investor on fund-by-fund basis.

III. Seeding Arrangements

A. There is a growing number of new entrants to the seed capital market, although demand for seed capital continues to exceed the supply.

B. A substantial number of recent notable launches have seed capital backing. New managers without seed capital have a more difficult time finding traction in the initial capital raising process.

C. The typical seed deal for $100 million to $200 million of capital provides the seeder with 15 percent to 25 percent of net revenues, gross revenues or gross revenues less certain expenses.

D. Typically seed capital is subject to a one- to three-year lock up.

E. The new manager is typically given a call right to buy back the seeder's interest after five years at a multiple of revenues, a percentage of assets under management or some other metric. Appropriate structuring of the payments for the call right can result in economic benefits to the seeded manager.

F. Additional structuring considerations are required for seed capital provided from non-U.S. seed providers to U.S.-based managers.

G. Some existing managers have added investment teams to their firms to manage a portfolio in-house while concurrently negotiating an agreement to eventually spin out the investment team under a formal seeding arrangement.

H. Some seeders have targeted previously established managers to provide them with "acceleration capital."

IV. Due Diligence

A. Investors and diligence firms continue to look for new stones to turn over in their diligence process as many asset allocators are concerned about their legal exposure for failing to perform adequate due diligence.

B. The due diligence period prior to receiving investment approval has increased. It is not uncommon for a new investor to require six or more due diligence meetings prior to making an investment with a manager.

C. In addition to pre-investment due diligence, more reporting and transparency is being required in connection with ongoing due diligence and the monitoring of investments.

D. Transparency (particularly, portfolio position transparency) continues to be a high priority for institutional investors.

V. Marketing Under the JOBS Act

A. The JOBS Act directs the SEC to amend Regulation D to remove the ban on general solicitation or general advertising for firms conducting offerings under Rule 506 of Regulation D, provided all purchasers of the securities are accredited investors.

B. Under the JOBS Act, public solicitation of investors in private funds will be permitted, provided that the fund sells only to accredited investors. The new rule will be a sales-based test and not an offer-based test.

C. The rules to be adopted under the JOBS Act are not finalized, but managers will be required to take reasonable steps to verify that investors are accredited.

D. Will managers take advantage of the JOBS Act?

1. The new rules will permit managers to speak more freely at conferences, speak with the press (including to correct misinformation) and do away with the requirement to “season” investors. The JOBS Act could offer “branding” opportunities for managers by allowing public dissemination about their funds and their firm.

2. Managers will still be subject to the anti-fraud rules under the Investment Advisers Act of 1940 (the “Advisers Act”) and other applicable securities laws. Accordingly all marketing materials, especially those that are publicly disseminated, will need to be carefully reviewed for compliance with the Advisers Act rules.

Note: Certain statistics in the outline were obtained from third party reports, including reports by Citi Prime Finance, Preqin and Hedge Fund Research, Inc.

US Managers Marketing in Europe: AIFM and Beyond

I. Summary

A. The Alternative Investment Fund Managers Directive ("AIFM Directive")[1] was agreed in November 2010, came into force in the European Union ("EU") on July 21, 2011 and must be implemented into the national law of all EU countries by July 22, 2013. The AIFM Directive sets forth rules for the authorization, operation and transparency (i.e., disclosure requirements) of managers of alternative investment funds ("AIFs"). The AIFM Directive will apply to any U.S. hedge fund manager (which would be defined under the AIFM Directive as an alternative investment fund manager or "AIFM") that:

1. Markets[2] one or more AIFs (EU or non-EU) to investors in the EU; or

2. Manages one or more EU AIFs.

B. The AIFM Directive will not apply to a U.S. AIFM managing a non-EU AIF where that non-EU AIF is not marketed to investors in the EU. A U.S. AIFM can accept an EU investor into a non-EU AIF without being subject to the AIFM Directive when the EU investor initiates the approach.

II. Background

A. The AIFM Directive is merely a framework and requires that the European Commission ("Commission") prepare detailed rules on a large number of the topics covered by the AIFM Directive in the form of subordinate legislation. Many[3] of the detailed rules, which expand upon the principles set forth in the AIFM Directive's initial framework, were adopted by the Commission on December 19, 2012 in the form of a delegated regulation (the "Delegated Regulation").[4] The Delegated Regulation and the other subordinate legislation under the AIFM Directive are known as the "Level 2 Measures" (with the AIFM Directive itself sometimes also referred to as "Level 1").

B. The Delegated Regulation expands in detail upon several principles in the AIFM Directive: conditions and procedures for the determination and authorization of AIFMs (including the capital requirements applicable to AIFMs), operating conditions for AIFMs (including rules on remuneration, conflicts of interest, risk management, liquidity management, investment in securitization positions, organizational requirements and rules on valuation), conditions for delegation, rules on depositaries (including the depositary's tasks and liability), reporting requirements and leverage calculation, and rules for cooperation arrangements and other issues relating to AIFs and AIFMs which are established outside the EU.

C. EU legislative procedures dictate that the text of the Delegated Regulation is now submitted to the European Parliament and the Council for their scrutiny over the course of the next three months. Provided that neither objects (any objection would cause the entire Delegated Regulation to be sent back to the Commission for revision), the Delegated Regulation will be adopted into EU law — around the end of March 2013.

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[1] Directive 2011/61/EU of the European Parliament and of the Council of June 8, 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF.

[2] Under the AIFM Directive, "marketing" means a direct or indirect offering or placement at the initiative of the AIFM, or on behalf of the AIFM, of units or shares of an AIF it manages to or with investors domiciled or with a registered office in the EU. (Article 4(1)(x) of the AIFM Directive).

[3] Not all of the Level 2 Measures were adopted by the Commission on December 19, 2012; several significant elements of the subordinate legislation still need to be adopted — most notably the new remuneration rules for AIFMs operating within the EU.

[4] http://ec.europa.eu/internal_market/investment/docs/20121219-directive/delegated-act_en.pdf. In implementing the detailed rules in the form of an EU regulation, the Commission has ensured that every country of the EU will have the same requirements for the management and marketing of AIFs as an EU regulation, once it comes into effect, is the *de facto* law of every country of the EU — without needing to be implemented or adopted into national law.

Initial indications are that neither the European Parliament nor the Council will oppose the text of the Delegated Regulation.

III. Scope of the AIFM Directive

A. An AIF is defined as any collective investment undertaking which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors (and which is not a UCITS[5]). Any such fund will fall within the definition of an AIF irrespective of whether it is open or closed-ended and irrespective of its legal structure.[6] Consequently, the AIFM Directive covers almost all funds — including hedge funds.

B. The AIFM Directive applies to any legal person appointed by or on behalf of the AIF whose regular business is managing one or more AIFs.[7] Under the AIFM Directive, "managing" an AIF means providing risk management or portfolio management services to the AIF,[8] although delegation by the manager — being the AIFM of that AIF — is permitted. Firms which provide portfolio or risk management services will therefore have to consider whether they have been appointed "by or on behalf" of the AIF — and, consequently, whether they are the AIFM — or whether they are only a delegate of the AIFM that was appointed by or on behalf of the AIF.

C. However, although the majority of the provisions of the AIFM Directive apply to EU AIFMs and EU AIFs, the AIFM Directive will also apply to any U.S. AIFM that is:

1. Marketing one or more EU AIFs to investors in the EU; or

2. Managing one or more EU AIFs.

IV. "Phased" Implementation for Non-EU AIFMs

A. The AIFM Directive is being implemented in phases, particularly those provisions applying to non-EU AIFMs. Initially, from July 22, 2013, the pan-EU marketing passport (which would allow an AIFM to market its AIF(s) to professional investors cross-border within the EU (without needing to consider private placement rules)) will only be made available to EU AIFMs with EU AIFs, meaning that AIFMs of non-EU AIFs or non-EU AIFMs of EU AIFs will need to continue to use existing national private placement rules in each EU country (where these exist)[9] — subject to compliance with certain operational conditions and disclosure requirements (see below). In addition, it is possible that some EU countries may require the manager of an AIF domiciled in their country to become registered with the national regulator (although the details for any such registrations are still unclear given there are still over six months until the new rules come into effect on July 22, 2013).

B. In 2015, the AIFM Directive requires that the European Securities and Markets Authority ("ESMA") must assess the functionality and effectiveness of the marketing passport for EU AIFMs with EU AIFs, and ESMA must provide its opinion to the European Commission regarding whether or not the marketing passport should be extended to non-EU AIFMs and non-EU AIFs.[10] If ESMA gives a positive opinion, then it is possible that the Commission could then make the marketing passport available to U.S. AIFMs in respect of non-EU AIFs. However, to obtain the marketing passport a U.S. AIFM would have to "opt-in" to the AIFM Directive registration rules and would have to register in

[5] An EU-regulated fund, akin to a mutual fund.

[6] Article 2(2) of the AIFM Directive.

[7] Recitals 6 and 20, and Article 4.1(b) of the AIFM Directive.

[8] Article 4(1)(w) of the AIFM Directive.

[9] National private placement rules are not harmonized and are specific to each EU country. Furthermore, not all EU countries permit interests in AIFs to be privately placed to investors in their jurisdiction and some of those countries that currently do permit private placements of AIF interests to their investors are contemplating removing their private placement rules for AIFs — notably Germany, which has proposed that to be eligible for marketing by way of private placement, the AIF would have to be registered with the German regulator.

[10] Recital 88 and Article 67 of the AIFM Directive.

the EU country where it intended to conduct the majority of its marketing activities.[11] U.S. AIFMs opting-in to the registration requirements would be required to comply with all of the AIFM Directive's rules, including the rules in relation to depositaries, regulatory capital, remuneration, leverage, valuations and other topics, and would also be required to have a legal representative or office within the EU country where the U.S. AIFM registered.[12]

C. However, the possibility of registering in the EU in 2015, if it were to be made available to U.S. AIFMs with non-EU AIFs, would be an optional registration; U.S. AIFMs with non-EU AIFs would still be able, if they wished, to continue to use national private placement rules. However, U.S. AIFMs with EU AIFs would be required to become registered in the EU at this time — provided that ESMA gives a positive opinion and the Commission makes the marketing passport available to U.S. AIFMs.

D. In 2018, ESMA is required to give a further opinion to the Commission on the functionality and effectiveness of the marketing passport for non-EU AIFMs.[13] If ESMA gives a positive opinion, then it is possible that, in early 2019, the Commission could repeal all national private placement rules in all EU countries in respect of AIF interests and could thereby require all AIFMs, when marketing any AIF in the EU, to become registered.

E. In summary

1. From now to July 22, 2013: U.S. AIFMs may continue to use national private placement rules as they have in the past.

2. July 22, 2013 to 2015: U.S. AIFMs may continue to conduct marketing in the EU using national private placement rules — subject to compliance with certain additional operational conditions and disclosure requirements (see below).

3. 2015 to 2018: U.S. AIFMs may, for non-EU AIFs, either continue to use national private placement rules or they may opt-in to the AIFM Directive to obtain the marketing passport; for U.S. AIFMs managing EU AIFs, the AIFMs may need to become registered in the EU and comply with the full AIFM Directive.

4. 2018 onwards: if ESMA gives a positive opinion and the Commission abolishes private placement rules, all AIFMs may be required to become registered in the EU to market to EU investors.

V. Operational Conditions and Disclosure Requirements for U.S. AIFMs Conducting Private Placements

A. For a U.S. AIFM to be able to market its AIF(s) in those EU countries which permit the private placement of AIF interests, three conditions must be complied with.[14]

1. Disclosure: the U.S. AIFM must comply with certain of the disclosure and transparency provisions in the AIFM Directive.[15]

(a) Making available an annual report for each non-EU AIF, which it markets in the EU[16] no later than six months following the end of the AIF's financial year and which must contain the information set forth below.[17]

[11] Article 37 of the AIFM Directive.

[12] Article 37(3) of the AIFM Directive.

[13] Recital 90 and Article 68 of the AIFM Directive.

[14] Article 42 of the AIFM Directive.

[15] Article 42(1)(a) of the AIFM Directive.

[16] This must be provided to investors on request and also be made available to the regulator(s) in the EU country or countries where the non-EU AIF is marketed.

[17] Article 22 of the AIFM Directive.

(b) Making a private placement memorandum (whose contents are compliant with the prescriptive requirements of the AIFM Directive) available to investors before they invest, as well as notifying them of any material changes in that information (for example, information on all fees, charges and expenses directly or indirectly borne by investors and the maximum amounts thereof, and details of any preferential treatment provided to an investor).[18]

(c) Reporting to the regulator in the EU country or countries where the AIF is marketed (including: (i) updated details of the percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature (i.e., side pocket arrangements); (ii) any new arrangements for managing the liquidity of the AIF; (iii) the current risk profile of the AIF and the risk management systems employed by the AIFM to manage the market risk, liquidity risk, counterparty risk and other risks including operational risk; and (iv) information on the main categories of assets in which the AIF has invested).[19]

2. Cooperation: appropriate information exchange agreements (described in the AIFM Directive as "appropriate cooperation arrangements for the purpose of systemic risk oversight"), which are aligned with international standards, must be in place between the regulator(s) of the EU country or countries where the AIFs are marketed, as well as the regulator(s) of the country where the AIF itself is established and the regulator of the country where the non-EU AIFM is established (i.e., for a U.S. AIFM that is a registered investment adviser, the SEC).[20]

3. FATF: Neither the non-EU AIFM nor the non-EU AIF should be established in a country which is listed by the Financial Action Task Force ("FATF") on anti-money laundering and terrorist financing measures as a "Non-Cooperative Country and Territory."[21]

(a) If any of these "minimum" conditions are not satisfied after July 22, 2013, then a U.S. AIFM would not be able to continue to market interests in the AIF to investors in the EU.

(b) It is worth noting that each EU country may impose stricter rules on non-EU AIFMs marketing interests in AIFs to potential investors in that particular country.[22] Consequently, the conditions referenced above may not be exhaustive and there could be additional requirements for marketing in any particular EU country.

(c) It is anticipated that the private placement rules in EU countries (where these exist) should remain until at least the end of 2018, when ESMA is required to report on whether the marketing passport is functional and effective and, consequently, whether private placement rules should be abolished or remain available to non-EU AIFMs who wish to conduct marketing to EU investors. If ESMA were to provide a positive opinion and if the European Commission were to abolish private placement rules in respect of interests in AIFs, this would mean that for a U.S. AIFM to market interests in its AIF in the EU, the U.S. AIFM would have to become registered in the EU.

VI. Reverse Solicitations

A. The AIFM Directive explicitly states that marketing activities by an AIFM are only covered by the AIFM Directive's rules where the marketing is done "at the initiative of

[18] Article 23 of the AIFM Directive.

[19] Article 24 of the AIFM Directive.

[20] Article 42(1)(b) of the AIFM Directive. It is anticipated that ESMA will develop a pro forma reporting template listing the relevant minimum information which ESMA considers should be exchanged between regulators pursuant to cooperation agreements.

[21] Article 42(1)(c) of the AIFM Directive. The list includes Iran, Bolivia, Cuba and Turkey.

[22] Article 42(2) of the AIFM Directive.

the AIFM or on behalf of the AIFM."[23] "Reverse solicitation" or "passive marketing" (being marketing which is at the initiative of the prospective investor) will continue to be permitted under the AIFM Directive, meaning that EU investors may continue to seek out, on their own initiative, and contact U.S. AIFMs about investing in non-EU AIFs. In such a situation the requirements above would not apply.

VII. Depositary Requirements

A. The AIFM Directive requires that all EU AIFs must have a depositary in the EU country where the AIF is established. This requirement applies irrespective as to whether or not the AIFM for that AIF is an EU AIFM or a non-EU AIFM.[24] Such depositary will be required to be responsible for:

1. The proper monitoring of the AIF's cash flows;

2. Ensuring that investor money and cash belonging to the AIF, or to the AIFM acting on behalf of the AIF, is booked correctly on accounts opened in the name of the AIF or in the name of the AIFM acting on behalf of the AIF or in the name of the depositary acting on behalf of the AIF for the safe-keeping of the assets of the AIF, including the holding in custody of financial instruments that can be registered in a financial instruments account opened in the depositary's books and all financial instruments that can be physically delivered to the depositary; and

3. The verification of ownership of all other assets by the AIF or the AIFM on behalf of the AIF.[25]

B. However, a non-EU AIF is exempt from the AIFM Directive requirement to have a depositary where it is managed by a non-EU AIFM and it is marketed in the EU via national private placement regimes (as opposed to being marketed under the marketing passport (assuming it becomes available in 2015, in which case the AIFM would have to ensure that one or more entities[26] were appointed to: (1) monitor the AIF's cash-flows; (2) ensure that the AIF's assets are held in custody appropriately; and (3) oversee the sale, issue, repurchase, redemption and cancellation of units or shares of the AIF)).

VIII. Annual Report Requirements

A. The AIFM Directive requires an AIFM to prepare an annual report in respect of each EU AIF it manages and each AIF it markets in the EU.[27] This must be completed no later than six months following the end of the AIF's financial year.[28] The accounting information given in the annual report must be prepared in accordance with:

1. For EU AIFs: the accounting standards of the AIF's home EU jurisdiction; or

2. For non-EU AIFs: the accounting standards of the non-EU country where the AIF is established.

3. And in accordance with the accounting rules laid down in the AIF rules or instruments of incorporation.

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[23] Article 4(1)(x) of the AIFM Directive.

[24] Article 21(5) of the AIFM Directive.

[25] Recital 37 to the AIFM Directive.

[26] Although the AIFM Directive specifies "one or more entities" in Article 36(1)(a), EU regulators have the option to choose whether or not a single entity must be appointed for the depositary-lite role or whether they would accept a number of entities conducting these activities. At the current time, the consultation paper from the U.K.'s Financial Services Authority proposes that non-EU AIFs managed by a U.K. AIFM must have a single entity appointed to conduct these activities. (See draft Rule 3.11.30 of the FSA's new FUND rulebook, which implements the AIFM Directive into U.K. regulations: http://www.fsa.gov.uk/static/pubs/cp/cp12-32.pdf).

[27] Article 22(1) of the AIFM Directive.

[28] Recital 48 and Article 22.1 of the AIFM Directive. However, those AIFs that are admitted to trading on an EEA-regulated market are required to prepare their annual report within four months of the end of their financial year.

B. The accounting information given in the annual report is required to be audited and prepared in accordance with the AIF's rules. The auditor's report, including any qualifications, must be reproduced in full in the annual report. EU AIFs must be audited in accordance with accounting standards in the AIF's home EU country. Where the AIF in question is a non-EU AIF (such as where a non-EU AIFM is marketing a non-EU AIF into the EU), the annual report must be audited in accordance with the international accounting standards in force in the country where the AIF has its registered office.[29]

C. The annual report must be provided to the following persons:

1. EU investors, on request; and

2. If the AIF is from the EU, the regulator of the EU country where the AIF is established; or

3. If the AIF is a non-EU AIF, the regulators of the countries of the EU into which the AIF is being marketed.

IX. Content of the Annual Report

A. The annual report must include the following information:

1. A balance sheet or statement of assets and liabilities, which must contain at least the following elements and underlying line items:[30]

(a) Assets comprising the resources controlled by the AIF as a result of past events and from which future economic benefits are expected to flow to the AIF. Assets must be sub-classified according to the following line items:

(i) "Investments," including, but not limited to, debt and equity securities, real estate and property and derivatives;

(ii) "Cash and cash equivalents," including, but not limited to, cash-in-hand, demand deposits and qualifying short-term liquid investments; and

(iii) "Receivables," including, but not limited to, amounts receivable in relation to dividends and interest, investments sold, amounts due from brokers and "prepayments," including, but not limited to, amounts paid in advance in relation to expenses of the AIF.

(b) Liabilities comprising present obligations of the AIF arising from past events, the settlement of which is expected to result in an outflow from the AIF of resources embodying economic benefits. Liabilities must be sub-classified according to the following line items:

(i) "Payables," including, but not limited to, amounts payable in relation to the purchase of investments or redemption of units or shares in the AIF and amounts due to brokers and "accrued expenses," including, but not limited to, liabilities for management fees, advisory fees, performance fees, interest and other expenses incurred in the course of operations of the AIF;

(ii) "Borrowings," including, but not limited to, amounts payable to banks and other counterparties; and

(iii) "Other liabilities," including, but not limited to, amounts due to counterparties for collateral on return of securities loaned, deferred income and dividends and distributions payable.

[29] Article 22(3) of the AIFM Directive.

[30] Article 22(2) of the AIFM Directive and Article 104 of the Delegated Regulation.

(c) Net assets representing the residual interest in the assets of the AIF after deducting all its liabilities.

2. An income and expenditure account, which must contain at least the following elements and underlying line items:

   (a) Income, representing any increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in net assets other than those relating to contributions from investors. Income must be sub-classified according to the following line items:

      (i) "Investment income," which must be further sub-classified as:

         (1) "Dividend income" relating to dividends on equity investments to which the AIF is entitled;

         (2) "Interest income" relating to interest on debt investments and on cash to which the AIF is entitled; and

         (3) "Rental income" relating to rental income from property investments to which the AIF is entitled.

      (ii) "Realized gains on investments," representing gains on the disposal of investments;

      (iii) "Unrealized gains on investments," representing gains on the revaluation of investments; and

      (iv) "Other income," including, but not limited to, fee income from securities loaned and from miscellaneous sources.

   (b) Expenses, representing decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in net assets, other than those relating to distributions to investors. Expenses must be sub-classified according to the following line items:

      (i) "Investment advisory or management fees," representing contractual fees due to the adviser or AIFM;

      (ii) "Other expenses," including, but not limited to, administration fees, professional fees, custodian fees and interest. Individual items, if material in nature, should be disclosed separately;

      (iii) "Realized loss on investments," representing loss on the disposal of investments; and

      (iv) "Unrealized loss on investments," representing loss on the revaluation of investments

   (c) Net income or expenditure, representing the excess of income over expenditure or expenditure over income, as applicable.

3. A report on activities of the AIF for the financial year, which must include a fair and balanced review of the activities and performance of the AIF, containing also a description of the principal risks and investment or economic uncertainties that the AIF might face. The report must include at least:[31]

[31] Article 105 of the Delegated Regulation.

(a) An overview of investment activities during the year or period, and an overview of the AIF's portfolio at year-end or period-end;

(b) An overview of the AIF's performance over the year or period; and

(c) A summary of any material changes that may have occurred during the financial year in the information presented in the AIF's disclosure document provided to investors before they make their investment (e.g., the AIF's offering memorandum/private placement memorandum).

4. Any material changes to the information required to be disclosed to investors pre-investment. For these purposes, "material" means any information that a reasonable investor, becoming aware of such information, would reconsider its investment in the AIF, including because such information could impact an investor's ability to exercise its rights in relation to its investment, or otherwise prejudice the interests of one or more investors in the AIF.[32]

5. The total remuneration for the financial year split into fixed and variable remuneration paid by the AIFM, the number of beneficiaries and details of carried interest paid, as well as the aggregate amount of remuneration broken down by senior management and members of staff whose actions have a material impact on the risk profile of the AIF (e.g., portfolio managers). The remuneration information disclosed is required to include:

(a) The total remuneration of the entire staff of the AIFM, indicating the number of beneficiaries;

(b) The total remuneration of those staff of the AIFM who are fully or partly involved in the activities of the AIF, indicating the number of beneficiaries;

(c) The proportion of the total remuneration of the staff of the AIFM attributable to the AIF, indicating the number of beneficiaries; and

(d) The carried interest paid by the AIF.

6. Where the information is disclosed at the level of the AIFM, an allocation or breakdown is required to be provided in relation to each AIF, but only to the extent that this information exists or is readily available. As part of the disclosure, a description must be provided of how the allocation or breakdown has been calculated.[33]

X. Disclosure to Investors

A. In addition to the annual report, the AIFM Directive requires that AIFMs must make certain other specific disclosures to investors, both prior to their investment in the AIF and periodically after they have invested.[34] The disclosure obligations apply to any AIFM managing EU AIFs and AIFMs, wherever in the world they are based, which are marketing EU or non-EU AIF to investors in the EU.

1. Pre-investment disclosure

(a) The information set out below must be made available to investors prior to investment, as well as updating investors as to any material changes.

(b) A description of the investment strategy and objectives of the AIF, together with:

[32] Article 106 of the Delegated Regulation.

[33] Article 107 of the Delegated Regulation.

[34] Article 23 of the AIFM Directive and Article 108 of the Delegated Regulation.

(i) Information on where any master AIF is established (if the AIF is a feeder AIF) and where the underlying funds are established (if the AIF is a fund of funds);

(ii) A description of the types of assets in which the AIF may invest;

(iii) The techniques the AIF may employ and all associated risks;

(iv) Any applicable investment restrictions;

(v) The circumstances in which the AIF may use leverage;

(vi) The types and sources of leverage permitted and the associated risks;

(vii) Any restrictions on the use of leverage and any collateral and asset reuse arrangements; and

(viii) The maximum level of leverage which the AIFM is entitled to employ on behalf of the AIF.

(c) A description of the procedures by which the AIF may change its investment strategy or investment policy, or both.

(d) A description of the main legal implications of the contractual relationship entered into for the purpose of investment, including information on jurisdiction, on the applicable law and on the existence or not of any legal instruments providing for the recognition and enforcement of judgments in the territory where the AIF is established.

(e) The identity of the AIFM, the AIF's depositary, auditor and any other service providers and a description of their duties and the investors' rights.

(f) A description of how the AIFM is complying with the requirement to cover its professional liability risks resulting from its activities as an AIFM with either: (i) compliance with an own funds requirement (to cover professional negligence); or (ii) professional indemnity insurance.

(g) A description of any delegated management functions which the AIFM may have delegated, and of any safe-keeping functions that may have been delegated by the AIF's depositary, the identification of the delegate and any conflicts of interest that may arise from such delegations.

(h) A description of the AIF's valuation procedure and of the pricing methodology for valuing assets, including the methods used in valuing hard-to-value assets.[35]

(i) A description of the AIF's liquidity risk management, including the redemption rights both in normal and in exceptional circumstances, and the existing redemption arrangements with investors.

(j) A description of all fees, charges and expenses and of the maximum amounts thereof which are directly or indirectly borne by the AIF's investors.

(k) A description of how the AIFM ensures a fair treatment of investors and, whenever an investor obtains preferential treatment or the right to obtain preferential treatment, a description of that preferential treatment, the type of investors who obtain such preferential treatment and disclosure of any legal or economic links with the AIF or AIFM.

(l) The latest annual report (referenced above).

[35] Article 19 of the AIFM Directive.

(m) The procedure and conditions for the issue and sale of units or shares.

(n) The most recent net asset value of the AIF or the latest market price of the unit or share of the AIF, in accordance with the AIFM's valuation procedures for that AIF.

(o) Where available, the historical performance of the AIF.

(p) The identity of the prime broker and a description of any material arrangements of the AIF with its prime brokers and the way the conflicts of interest in relation thereto are managed and the provision in the contract with the depositary on the possibility of transfer and reuse of AIF assets, and information about any transfer of liability to the prime broker that may exist.

(q) The percentage of the AIF's assets which are subject to special arrangements (such as side pockets, gates or other similar arrangements) arising from their illiquid nature — calculated as the net value of those assets subject to special arrangements divided by the net asset value of the AIF concerned.[36]

(r) Any new arrangements for managing the liquidity of the AIF, including:

  (i) Immediately notifying investors where the AIFM activates gates, side pockets or similar special arrangements or where the AIFM decides to suspend redemptions; and

  (ii) Providing investors with an overview of any changes to arrangements concerning liquidity, whether or not these are special arrangements. Where relevant, the terms under which redemption is permitted and circumstances determining when management discretion applies must be included as must any voting or other restrictions exercisable, the length of any lock-up or any provision concerning "first in line" or "pro-rating" on gates and suspensions.[37]

(s) The current risk profile of the AIF and the risk management systems employed by the AIFM to manage those risks, with details in the disclosure of:

  (i) Measures to assess the sensitivity of the AIF's portfolio to the most relevant risks to which the AIF is or could be exposed; and

  (ii) The remedial measures taken by the AIFM in circumstances where any risk limits set by the AIFM have been or are likely to be exceeded.[38] The information is required to be disclosed as part of the AIF's periodic reporting to investors, at the same time as the offering memorandum is disclosed or updated to investors, and, as a minimum, at the same time as the annual report is made available or made public.[39]

(t) Any changes to the maximum level of leverage which the AIFM may employ on behalf of the AIF, as well as a description of the nature of any rights granted by the AIFM for the reuse of collateral or the nature of any guarantees granted under the leveraging arrangement.[40]

(u) The total amount of leverage employed by that AIF.[41]

B. The disclosures must be presented in a clear and understandable way.

[36] Article 108(2) of the Delegated Regulation.

[37] Article 108(3) of the Delegated Regulation.

[38] Article 108(4) of the Delegated Regulation.

[39] Article 108(5) of the Delegated Regulation.

[40] Article 109(2) of the Delegated Regulation.

[41] Article 109(3) of the Delegated Regulation.

C. Many of the disclosures listed above are comparable to those traditionally covered in an AIF's offering memorandum or private placement memorandum, but others, such as the remuneration disclosure, are likely to be new — particularly for non-EU AIFMs.

XI. Changes to Information

A. Material changes to this information must also be disclosed to investors (through an updated prospectus or offering memorandum), and *any* change to depositary liability must be notified without delay.[42]

XII. Reporting to Regulators

A. The AIFM Directive also specifies that the following reports must be made regularly* by an EU AIFM — and by any non-EU AIFMs that opt-in to the AIFM Directive requirements to obtain the benefit of the marketing passport — to its EU regulator.

1. The principal markets and instruments on and in which the AIFM trades,[43] together with reports as to:

   (a) The main instruments in which the AIFM is trading, including a break-down of financial instruments and other assets, including the AIF's investment strategies and their geographical and sectoral investment focus;

   (b) The markets of which the AIFM is a member or where it actively trades; and

   (c) The diversification of the AIF's portfolio, including, but not limited to, its principal exposures and most important concentrations.[44]

2. The main categories of assets in which the AIF is invested, including the corresponding short market value and long market value, the turnover and performance during the reporting period.

3. The percentage of assets in each AIF which are subject to special arrangements because they are illiquid (for example, side pocket arrangements).

4. Any new liquidity management arrangements.

5. The risk profile of the AIF and the risk management tools employed by it to manage market risk, liquidity risk, counterparty risk and other risks including operational risks.

6. The results of the stress tests required by the AIFM Directive in respect of position risk and liquidity risk management.

   *The level of frequency when the disclosures have to be made depends upon the size of the assets under management by the AIFM (whether in the EU or not). The information listed above is required to be reported.[45]

7. On a half-yearly basis by AIFMs managing portfolios of AIFs whose aggregate assets under management in total exceed either €100 million (including any assets acquired through leverage) or €500 million (where the AIF is unleveraged and redemption rights are not exercisable for five years following the date of initial investment) but do not exceed €1 billion, for each of the EU AIFs the AIFM manages and for each of the AIFs the AIFM markets in the EU.

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[42] Article 23(2) of the AIFM Directive.

[43] Article 24(1) of the AIFM Directive.

[44] Article 110 of the Delegated Regulation.

[45] Article 110(3) of the Delegated Regulation.

8. On a quarterly basis by AIFMs managing portfolios of AIFs whose assets under management in total exceed €1 billion, for each of the EU AIFs they manage, and for each of the AIFs they market in the EU.

9. On a quarterly basis by AIFMs which are subject to the requirements referred to in point (a) above, for each AIF whose assets under management, including any assets acquired through use of leverage, in total exceed €500 million, in respect of that AIF.

10. On an annual basis by AIFMs in respect of each unleveraged AIF under their management which, in accordance with its core investment policy, invests in non-listed companies and issuers in order to acquire control.

XIII. Leverage Reporting

A. Any AIFM which manages an EU AIF or which markets a non-EU AIF into the EU where that AIF employs leverage on a "substantial basis" has additional reporting requirements.[46] In the Delegated Regulation, the Commission stated that leverage shall be considered to be employed on a "substantial basis" when the exposure of an AIF (as calculated according to the commitment method)[47] exceeds three times its net asset value.[48] The additional leverage reporting required by AIFMs managing AIFs employing leverage on a substantial basis is:

1. The overall level of leverage employed by each such AIF that the AIFM manages, with a breakdown between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives;

2. The extent to which each AIF's assets have been re-used under leveraging arrangements; and

3. The identity of the five largest sources of borrowed cash or securities for each of the AIFs managed by the AIFM, and the amount of leverage received from each of those entities for each of those AIFs.[49]

XIV. Additional Reporting Requirements

A. In exceptional circumstances and where required to ensure the stability and integrity of the financial system, or to promote long-term sustainable growth (whether or not there are exceptional circumstances), ESMA has a wide discretion to be able to request that national EU regulators impose additional reporting requirements on AIFMs. Therefore, EU regulators could potentially require that AIFMs disclose any additional information necessary for the effective monitoring of systemic risk. Until ESMA uses this new power it is difficult to foresee what additional disclosures may be required in the future.

[46] Article 24(4) of the AIFM Directive.

[47] Article 8 of the Delegated Regulation.

[48] Article 111 of the Delegated Regulation.

[49] Article 24(4) of the AIFM Directive.

XV. Summary

Period — From now until July 22, 2013	
U.S. AIFM managing EU AIF(s)	Business as usual.
U.S. AIFM managing non-EU AIF(s)	Business as usual.

Period — From July 22, 2013 until July 21, 2015			
	No marketing conducted in EU countries	**Marketing in EU countries using national private placement rules ("NPPRs")**	**Marketing in EU countries using passport**
U.S. AIFM managing EU AIF(s)	Non-EU AIFM must comply with national authorization requirements applicable in the relevant EU country where the AIF is established.[50]	Transparency requirements must be complied with by the non-EU AIFM for the EU AIF(s) — annual reports, disclosure to investors, reporting to regulators (and compliance with rules for any AIFM acquiring substantial stakes in EU companies). Conditions 1 and 2 of Third Country Conditions must be satisfied.[51]	Not relevant.
U.S. AIFM managing non-EU AIF(s)	Not relevant.	Transparency requirements must be complied with by the non-EU AIFM for the EU AIF(s) — annual reports, disclosure to investors, reporting to regulators (and compliance with rules for any AIFM acquiring substantial stakes in EU companies). Conditions 1 and 2 of Third Country Conditions must be satisfied.[52]	Not relevant.

[50] Article 37 of the AIFM Directive.

[51] Article 42 of the AIFM Directive.

[52] Article 42 of the AIFM Directive.

Period — From July 22, 2015 until July 21, 2018			
	No marketing conducted in EU countries	**Marketing in EU countries using NPPRs**	**Marketing in EU countries using passport**
U.S. AIFM managing EU AIF(s)	Non-EU AIFM must become authorized by the regulator of its Member State of Reference and comply with full AIFM Directive regime. AIFM must appoint a legal representative in its Member State of Reference. Conditions 1, 2 and 3 of Third Country Conditions must be satisfied.[53]	Non-EU AIFM must become authorized by the regulator of its Member State of Reference and comply with full AIFM Directive regime. AIFM must appoint a legal representative in its Member State of Reference. Conditions 1, 2 and 3 of Third Country Conditions must be satisfied.[54]	Non-EU AIFM must become authorized by the regulator of its Member State of Reference and comply with full AIFM Directive regime. AIFM must appoint a legal representative in its Member State of Reference. Conditions 1, 2 and 3 of Third Country Conditions must be satisfied.[55]
U.S. AIFM managing non-EU AIF(s)	Not relevant.	Transparency requirements must be complied with by the non-EU AIFM for the EU AIF(s) — annual reports, disclosure to investors, reporting to regulators (and compliance with rules for any AIFM acquiring substantial stakes in EU companies). Conditions 1 and 2 of Third Country Conditions must be satisfied.[56]	Non-EU AIFM must become authorized by the regulator of its Member State of Reference. AIFM must comply with full AIFM Directive regime. AIFM must appoint a legal representative in that Member State. Conditions 1, 2 and 3 of Third Country Conditions must be satisfied.[57]

[53] Article 37 of the AIFM Directive.

[54] Article 37 of the AIFM Directive.

[55] Articles 37, 38 and 39 of the AIFM Directive.

[56] Article 42 of the AIFM Directive.

[57] Article 40 of the AIFM Directive.

Period — From July 22, 2018 onwards (if NPPRs phased out)			
	No marketing conducted in EU countries	**Marketing in EU countries using NPPRs**	**Marketing in EU countries using passport**
U.S. AIFM managing EU AIF(s)	Non-EU AIFM must become authorized by the regulator of its Member State of Reference. AIFM must comply with full AIFM Directive regime. AIFM must appoint a legal representative in that Member State. Conditions 1, 2 and 3 of Third Country Conditions must be satisfied.[58]	Not available.	Non-EU AIFM must become authorized by the regulator of its Member State of Reference and comply with full AIFM Directive regime. AIFM must appoint a legal representative in its Member State of Reference. Conditions 1, 2 and 3 of Third Country Conditions must be satisfied.[59]
U.S. AIFM managing non-EU AIF(s)	Not relevant.	Not available.	Non-EU AIFM must become authorized by the regulator of its Member State of Reference and comply with full AIFM Directive regime. AIFM must appoint a legal representative in its Member State of Reference. Conditions 1, 2 and 3 of Third Country Conditions must be satisfied.[60]

[58] Article 37 of the AIFM Directive.

[59] Articles 37, 38 and 39 of the AIFM Directive.

[60] Articles 37, 38 and 39 of the AIFM Directive.

XVI. Third Country Conditions

A. Appropriate cooperation arrangements — which must be in place between the regulator of the home country of the AIFM and the regulator(s) of the country where the non-EU AIF is established and the regulator(s) of the relevant EU countries where the AIF is to be marketed — to ensure at least an efficient exchange of information to allow the EU regulator to carry out its duties under the AIFM Directive.

B. The third country where the non-EU AIF is established must not be listed as Non-Cooperative Country and Territory by the Financial Action Task Force on anti-money laundering and terrorist financing;[61] and

C. The third country where the non-EU AIF is established must have signed an agreement with each EU country in which the shares or units of the non-EU AIF are proposed to be marketed, fully complying with the standards laid down in Article 26 of the OECD Model Tax Convention and ensuring an effective exchange of information in tax matters, including, if any, multilateral tax agreements.

[61] For more information, *see*: http://www.fatf-gafi.org/.

Opportunities for Hedge Fund Managers in the Registered Funds Space

I. Background

A. Industry trends and developments

1. In recent years, mutual fund advisers and other financial intermediaries (including broker-dealers, banks, financial advisers and insurance companies) have begun to add alternative investments to their product menus and recommended client portfolio allocations.

2. Some firms have built their own infrastructures to deliver alternative investment products. Others have partnered with managers of private investment funds, formed joint ventures to offer these products or acquired hedge fund management firms.

3. One reason for these developments has been the accumulation of wealth among individual investors and the resulting increased focus by traditional advisory firms and financial intermediaries on selling products to high-net-worth investors and to the “mass affluent.”

4. Another reason is that more financial intermediaries are recommending allocation of clients’ assets to alternative investments and strategies that seek to provide “absolute returns.”

5. Alternative investment products also offer a way for traditional asset managers and fund distributors to: enhance revenues (from performance-based compensation structures); diversify sources of revenues; offer new opportunities to portfolio managers and retain key talent; and satisfy the growing appetite of investors for alternative investments.

6. The investment adviser of a registered fund — that is, an investment company registered under the Investment Company Act of 1940 (the “1940 Act”) — must be a registered investment adviser. The Dodd-Frank Act has required the registration of many advisers to hedge funds and other private investment funds. One side effect of this requirement is that the universe of private advisers eligible to sponsor and manage registered funds has grown.

7. A 1997 amendment of Subchapter M of the Internal Revenue Code of 1986 (the “Code”) (which governs the taxation of mutual funds) made it easier for registered investment companies to use certain investment techniques consistent with applicable qualification requirements. The amendment eliminated the so-called “short-short” test which would disqualify a mutual fund from taxation under Subchapter M if more than 30 percent of its gross income was derived from short-term trading.

B. Use of registered funds to offer alternative investments

1. Unlike private investment funds, registered funds are not subject to various restrictions on investor eligibility or to limits on the number of their investors.

2. Advisory firms and financial intermediaries seeking to deliver alternative investment strategies to a broader market are making increased use of 1940 Act registered funds. These products are sometimes referred to as “registered alternative funds” or “registered hedge funds.”

II. Benefits of 1940 Act Registration

A. Broader flexibility in offerings

1. Private investment funds rely on Section 3(c)(1) or Section 3(c)(7) of the 1940 Act to eliminate the requirement for investment company registration. The requirements of these provisions constrain offerings of interests in private funds.

   (a) Section 3(c)(1) requires that a fund be sold in a private offering and limit the number of beneficial owners of interests in the fund to not more than 100 persons.

   (b) Section 3(c)(7) requires that a fund be sold in a private offering and that investors be limited to persons who are "qualified purchasers" as defined by Section 2(a)(51) of the 1940 Act (generally, individuals who own "investments" of $5 million or more and entities that own "investments" of $25 million or more).

   (c) The private offering requirements of Section 3(c)(1) and Section 3(c)(7) essentially require that offerings be made only to "accredited investors," as defined by Rule 501 of Regulation D under the Securities Act of 1933 (the "1933 Act") (generally, individuals having a net worth of more than $1 million or annual income in excess of $200,000).

2. Registration of a fund under the 1940 Act allows the fund to have more than 100 investors, without the need to sell interests in the fund only to qualified purchasers. This makes the registered fund better suited to broad offerings by brokerage firms and financial advisory firms who have large numbers of clients, many of whom are not qualified purchasers. Also, the elimination of the 100 investor limit enables product sponsors to set lower minimum initial investment requirements without adversely affecting the amount of assets that can be raised.

3. A registered fund can make a public offering by registering its shares under the 1933 Act. A registered fund that makes a public offering need not limit its offering to persons who are "accredited investors," may use advertising and may offer its securities to persons with whom it does not have a pre-existing substantive relationship.

B. Other benefits of 1940 Act registration

1. Generally, a private fund's assets will be deemed "plan assets" for purposes of the Employee Retirement Income Security Act of 1974 ("ERISA") if 25 percent or more of the value of interests in the fund are owned by ERISA plans. Section 401(b)(1) of ERISA, however, explicitly provides that the assets of a fund registered under the 1940 Act are not plan assets.

   (a) Regardless of the extent of ownership by employee benefit plans, a registered fund's assets will not be plan assets and ERISA constraints will not apply to the management and investment of those assets.

   (b) A number of registered hedge funds (particularly, certain hedge funds of funds) have been designed to facilitate investment by ERISA plans without triggering ERISA requirements.

2. Advisers of registered funds that make use of commodity futures and other commodity interests have a somewhat greater ability than private fund managers to avoid various regulatory requirements imposed by the Commodity Futures Trading Commission ("CFTC") without the need to restrict their investors to persons who are "qualified eligible persons" ("QEPs"), as defined by CFTC regulations. Generally, QEPs would include individual investors who are accredited investors and have at least $2 million of aggregate positions in futures and securities and entities that have at least $5 million in total assets.

(a) Rule 4.13(a)(3) under the Commodity Exchange Act of 1974 (the "CEA") provides an exemption from registration as a commodity pool operator (a "CPO") to the manager of a private investment fund if the fund's use of commodity interests is limited so as to meet one of two de minimis tests and the fund is not marketed as a commodity pool or as a vehicle for trading in commodities.

(b) The adviser of a registered fund may avail itself of an exemption from CPO registration if similar requirements are met. However, in determining compliance with the de minimis tests, commodity interests used for "bona fide hedging" purposes need not be considered.

(c) Suitability limitations of various state laws applicable to sales of interests in commodity pools do not apply to registered funds.

(d) Rule 482 under the 1933 Act provides publicly offered registered funds broad flexibility to make use of advertising, whereas any sales materials used by a publicly offered commodity pool (other than "tombstone" advertisements) need to be preceded by or accompanied with a prospectus.

3. NASD Conduct Rule 2790 (*Restrictions on the Purchase and Sale of Initial Equity Public Offerings*) prohibits broker-dealers from allocating to specified "restricted persons" shares being sold in public offerings of "new issues" of equity securities that trade at a premium in the secondary market. As a practical matter, the rule requires that private funds create a "carve out" so that profits from new issues are allocated only to persons who are not restricted. The prohibitions of the Rule 2790 do not apply to sales of new issues to registered funds.

III. Key Implications of 1940 Act Registration

A. Applicability of 1940 Act investment restrictions

1. Registered funds are subject to certain investment limitations imposed by the 1940 Act. Among other things, Section 18 of the 1940 Act limits the use of leverage by imposing an asset coverage requirement applicable to the issuance of "senior securities."

2. The use of registered funds is feasible for delivering alternative investment strategies to investors only where the investment programs fit within the 1940 Act regulatory scheme. However, most hedge fund investment programs, including those involving short sales of securities, are feasible under the 1940 Act, except for certain strategies that are highly leveraged. Highly leveraged strategies may nonetheless be feasible if implemented through the use of derivatives that do not create significant leverage for 1940 Act purposes.

B. Prohibitions on transactions with affiliates

1. The 1940 Act and the rules thereunder contain various provisions (e.g., Section 17(a) and Rule 17d-1) that generally prohibit affiliated persons of a registered fund, and affiliated persons of such persons, from engaging in any principal transaction, or any joint enterprise or other joint arrangement, with the registered fund.

2. These provisions need to be considered carefully; particularly, in the context of managing a registered hedge fund of funds. Generally, a hedge fund will be an affiliated person of a registered hedge fund of funds where: (i) the adviser of the registered fund of funds is affiliated with the general partner/adviser of the hedge fund; (ii) the registered fund of funds owns five percent or more of the outstanding voting securities of the hedge fund; or (iii) funds and other accounts managed by the adviser of the registered fund of funds (including the registered fund) own, in the aggregate, five percent or more of the outstanding voting securities of the hedge fund (Section 2(a)(3) of the 1940 Act).

3. The prohibitions on affiliated transactions would also generally prohibit a registered fund from purchasing securities from or selling securities to an affiliated person of its investment adviser (including private investment funds managed by the registered fund's investment adviser) and would permit the use of a broker-dealer affiliated with the registered fund's adviser to effect securities transactions on an agency basis, subject to a condition that the commissions paid to the affiliated broker do not exceed the "usual and customary" broker's commission.

C. "Corporate governance" requirements

1. The 1940 Act imposes certain governance requirements, which require registered funds to have "independent directors" and require that these directors (and sometimes also shareholders of the funds) approve certain matters.

2. Among other requirements, investment advisory agreements and distribution agreements must be approved by a majority of the independent directors. These agreements may have initial terms of two years and can continue in effect thereafter only if approved annually by a majority of the independent directors. In addition, the agreements must provide for automatic termination in the event of an "assignment" and for termination by the registered fund on not more than 60 days notice.

D. Recordkeeping rules and SEC examinations

1. Rule 31a-1 under the 1940 Act requires that registered funds maintain certain specified books and records.

2. Section 31(b) of the 1940 Act provides that these books and records are subject to reasonable periodic, special and other examinations by the SEC and its staff.

E. Public reports

1. Registered funds must send audited annual reports and unaudited semi-annual reports to their investors within 60 days after the end of the applicable fiscal period. These periodic reports, which are also filed with the SEC, contain financial statements, including statements of investments that identify all investments held by the funds. In addition, registered funds must file reports with the SEC showing their investment holdings as of the end of their first and third fiscal quarters.

2. The reports filed with the SEC are publicly available. Sarbanes-Oxley certification requirements are applicable, which means that a registered fund's principal executive officer and principal financial officer must certify the accuracy of the information contained in a registered fund's financial reports.

F. Administration and compliance issues

1. Operating a registered fund requires implementation of systems to assure compliance with the 1940 Act and other laws.

(a) Rule 38a-1 under the 1940 Act requires that registered funds adopt policies and procedures reasonably designed to prevent violations of the federal securities laws. A registered fund must also appoint a chief compliance officer ("CCO"). A fund's compliance program and its CCO must be approved by the independent directors of the fund, and the independent directors must also approve the CCO's compensation.

(b) On an annual basis, the CCO must review the adequacy of the compliance program and provide a report to the fund board regarding that review.

(c) There is no prohibition on the CCO of a registered fund's adviser also serving as CCO of the registered fund.

2. In addition, the adviser of a registered fund or another organization will have to furnish necessary fund accounting and transfer agent services. An outside administrator and transfer agent can be retained by a fund to supply these services. Frequently, the functions of an administrator will include supervision of regulatory and tax compliance.

IV. Registered Alternative Fund Products

A. Types of investment programs

1. Registered funds are being used to deliver various types of alternative investment programs.

2. Alternative investment strategies used by registered funds include: single manager/strategy hedge funds (e.g., long/short, market neutral, hedged equity); sector and multi-sector hedge funds; private equity funds; crossover funds; hedge funds of funds; real estate funds; and real assets/commodities funds.

B. Taxation of registered funds

1. Generally, most registered funds seek to qualify as "regulated investment companies" ("RICs"). This enables the funds to avoid entity level taxation if certain required distributions are made to investors and also enables the funds to provide simplified tax reporting to investors on Form 1099.

2. Registered funds can also be taxed as partnerships, in which case tax reporting to investors is provided on Form K-1. If a registered fund is taxed as a partnership, it does not have to meet any of the requirements applicable to RICs. However, there is a strong preference in retail distribution channels for reporting on Form 1099 and, as a result, most registered funds designed for broad retail distribution elect to be taxed as RICs.

3. To qualify as a RIC, a registered fund must meet a quarterly diversification test as well as an annual test relating to the source of its income.

(a) Under the diversification test, as of the end of each taxable quarter, at least 50 percent of a RIC's assets must be represented by: cash; U.S. government securities; securities of other RICs and other securities as to which the RIC's investment is limited in respect to any issuer to an amount not greater than five percent of the value of the RIC's total assets and not greater than 10 percent of the outstanding voting securities of such issuer. In addition, a RIC generally may not invest more than 25 percent of its assets in the securities (other than U.S. government securities and securities of other RICs) of any one issuer or in the securities of one or more qualified publicly traded partnerships.

(b) Under the source of income test, at least 90 percent of a RIC's gross income during its taxable year must be derived from: dividends; interest; payments with respect to securities loans; gains from the sale or other disposition of stock; securities or foreign currency; certain other income (including, but not limited to, gains from options, futures and forward contracts) derived with respect to its business of investing in stock, securities or currencies; or from net income derived from an interest in a qualified publicly traded partnership. For purposes of this test, non-qualifying (or "bad") income would include income derived from: non-financial commodities; direct ownership of real estate and rents from real property; certain unincorporated entities; and intangibles, such as trademarks, patents and royalties.

(c) RICs sometimes use "blocker" entities taxable as corporations for U.S. tax purposes to hold investments that would generate bad income if held directly by a RIC in order to facilitate their investment programs.

(d) Funds taxed as partnerships are typically organized as limited liability companies or limited partnerships. Funds taxed under Subchapter M are typically organized as business (or statutory) trusts or as corporations.

C. Closed-end product structures

1. Registered funds are sometimes structured as closed-end investment companies. A closed-end investment company is a fund that issues interests that are not redeemable at the option of the investor. Investors in a closed-end fund can be provided with liquidity similar to the liquidity of an investment in a hedge fund by means of repurchase offers made by the fund, or can be given liquidity similar to the liquidity of an investment in a private equity fund by providing for distributions to investors only after underlying investments of the fund are sold or become liquid. Alternatively, shares of a registered fund can be listed for trading on a securities exchange, which would provide daily liquidity to investors but would not impact fund cash flows. Thus, an exchange-listed registered fund is a "permanent capital" vehicle.

(a) The provisions of Rule 22c-1 under the 1940 Act require that shares of open-end funds (i.e., funds that issue redeemable securities) be redeemable on a daily basis. A closed-end structure avoids this requirement and thus, controls cash outflows from a fund.

(b) Under SEC interpretations of Section 22(e) of the 1940 Act, an open-end fund may not invest more than 15 percent of its assets in illiquid securities. Thus, an open-end structure is not feasible for registered funds that invest more than 15 percent of their assets in illiquid securities (e.g., registered hedge funds of funds, registered private equity funds and certain distressed funds).

2. Registered funds can have fee structures that are similar to those of private investment funds (e.g., an asset-based management fee and a performance-based incentive allocation or incentive fee that is a specified percentage of net profits). However, the use of performance-based compensation requires that interests be sold only to "qualified clients."

(a) Rule 205-3 under the Advisers Act provides an exemption from the general Advisers Act prohibition on performance fees where a registered fund is sold only to persons who are "qualified clients" (generally, a person with a net worth of more than $2 million, excluding the value of their principal residence, or who has at least $1 million under the management of the fund's adviser and its affiliates).

(b) Under the provisions of Rule 205-3, interests in a registered hedge fund of funds that does not impose a performance-based fee (or allocation) must also be sold only to qualified clients if the registered fund invests in any hedge fund that: (i) has a performance-based compensation arrangement; (ii) relies on Section 3(c)(1) of the 1940 Act; and (ii) is managed by a registered adviser (Rule 205-3 requires a "look through" to the investors in the registered fund when determining whether the investors in the underlying hedge fund are qualified clients).

(c) As a practical matter, a registered fund that pays performance-based compensation cannot be listed or traded on a securities exchange because presently there are no mechanisms that would enable the fund to restrict share ownership to investors who are qualified clients.

3. A registered closed-end fund that is not traded on an exchange can be structured to have features similar to a hedge fund. For example, such a fund can be privately offered, impose a performance fee or incentive allocation, be taxed as a partnership and provide periodic liquidity to investors through repurchase offers.

4. Non-publicly traded closed-end funds typically provide liquidity to investors by making offers to repurchase interests. Repurchase offers may be made in reliance on Rule 13e-4 (the issuer repurchase rule) under the Securities Exchange Act of

1934 Act (the "1934 Act") or in reliance on Rule 23c-3 under the 1940 Act (the "interval fund" rule). In both cases, interests in a fund are repurchased based on the net asset value of the interests, determined as of a specified valuation date.

(a) Funds that do not rely on Rule 23c-3 cannot promise to make repurchase offers at specified periodic intervals. Such funds, however, can make repurchase offers on a regular basis, but each such offer must be approved by the fund's board.

(b) A fund that relies on Rule 23c-3 is required to make offers to repurchase at a specified interval (either quarterly, semi-annually or annually) and in each offer must offer to purchase a specified amount of interests equal to at least five percent, but not more than 25 percent of outstanding interests. Various other conditions are imposed by Rule 23c-3.

(c) The conditions of Rule 23c-3 governing the timing and pricing of repurchase offers make it difficult for registered hedge funds of funds to rely on the rule. Thus, registered hedge funds of funds make repurchase offers in reliance on Rule 13e-4.

(d) A registered fund that is taxed as a partnership must limit the frequency of its repurchase offers (and restrict transfers of interests) to avoid becoming a publicly traded partnership. Interests in the fund must not be redeemable or readily tradable. Semi-annual offers, and quarterly offers with a notice requirement of 65 days, are typically viewed as acceptable in this regard.

5. Depending on the combination of features that a registered closed-end fund has, such a fund can have more of the look and feel of a private investment fund or the look and feel of a mutual fund. The nature of the investor and the intended distribution channel generally play an important role in product design. For example, a large brokerage firm with retail distribution will generally prefer a more "user friendly" product design: a publicly offered fund (which avoids the need to comply with rules applicable to private placements) that relies on Rule 23c-3 and is taxed as a RIC.

D. Open-end product structures

1. Recently, there has been a growing number of registered open-end investment companies (mutual funds) that pursue hedge fund-like investment programs.

2. The investment strategies of these funds include: equity long/short funds; market neutral funds; 130/30 funds; merger arbitrage and other hedge fund strategies. The funds include multi-manager funds where different hedge fund managers are responsible for managing separate "sleeves" of the funds' portfolios.

3. Morningstar and Lipper have created new fund categories for "hedge like" mutual funds.

4. Mutual funds have sometimes made use of derivatives to implement investment programs involving alternative investment strategies in a manner consistent with 1940 Act restrictions (including leverage limitations). For example, a few mutual funds have used total return swaps to capture (on a leveraged basis) the investment performance of a basket of designated hedge funds, and thus provide investment risk/return characteristics similar to those of a hedge fund of funds.

5. 1940 Act leverage limitations applicable to open-end funds differ from those that apply to closed-end funds. For example, a mutual fund may not borrow money, except from a bank. Such borrowings are subject to a 300 percent asset coverage requirement (meaning that a fund needs $3 in total assets for each $1 of borrowings. In addition, investment positions that constitute "senior securities" for 1940 Act purposes (i.e., positions where a fund's potential obligations exceed the amount of its investment) are not permitted. However, these positions are permissible if the fund segregates on its books (or on the books of its custodian

bank) liquid assets having a value (marked-to-market daily) at least equal to the amount of its potential obligations.

6. Rule 22c-1 under the 1940 Act requires that mutual funds determine the net asset value of their shares and honor requests for redemptions of shares on a daily basis. Under Section 22(e) of the 1940 Act, mutual funds must make payment of redemption proceeds within seven days absent certain specified extraordinary circumstances (such as when the New York Stock Exchange is closed other than for customary closings). Because of these requirements, the SEC and its staff take the position that mutual funds may not invest more than 15 percent of their assets in illiquid securities (10 percent in the case of money market funds).

7. Generally, mutual funds are publicly offered on a continuous basis, and investors can purchase shares on a daily basis. For this reason, mutual funds must periodically update their prospectuses and other disclosure documents by filing post-effective amendments to their registration statements with the SEC.

8. Performance-based compensation can be paid by a mutual fund if the fund limits its investors to persons who are "qualified clients" as defined by Rule 205-3 under the Advisers Act. However, rules under the Advisers Act permit mutual funds (as well as closed-end funds), subject to various conditions, to use "fulcrum fees" under which there can be a performance-based component of the advisory fee where the fee increases or decreases proportionately relative to the performance of the fund as compared to a benchmark index.

9. Generally, mutual funds need to qualify as RICs to avoid entity-level taxation (because the publicly traded partnership rules preclude partnership taxation).

V. Registered Hedge Funds of Funds

A. Fund characteristics

1. Registered hedge funds of funds are structured as closed-end funds.

2. Interests in registered hedge funds of funds have been offered in both private and public offerings.

3. The form of organization has typically been a limited liability company, except for funds that have elected to be taxed as RICs, which have typically been organized as trusts.

4. Interests in registered hedge funds of funds have not been publicly traded and liquidity is provided by means of repurchase offers, which are generally made pursuant to Rule 13e-4 under the 1934 Act.

B. Application of 1940 Act provisions

1. The "fund of funds" restrictions of Section 12(d)(1) of the 1940 Act were amended in 1996 and no longer restrict the ability of a registered fund to invest in hedge funds or other types of private investment funds.

2. Investment in any one underlying hedge fund may not exceed 40 percent of a registered fund's assets. Under applicable SEC staff interpretations, an investment in excess of this amount could result in the registered fund being deemed to be "formed for the purpose" of investing in the hedge fund, and the hedge fund would need to "look through" to the investors in the registered fund in determining its eligibility to rely on the exclusions made available by Section 3(c)(1) and Section 3(c)(7) of the 1940 Act. This would probably result in the hedge fund being unable to rely on either of those provisions because the registered fund in all likelihood would have more than 100 investors or would have investors who are not qualified purchasers.

3. A hedge fund relying on Section 3(c)(1) of the 1940 Act needs to prohibit any registered fund from purchasing 10 percent or more of the outstanding interests in the hedge fund. The purchase by a registered fund of an interest exceeding this limit would require the hedge fund to count investors in the registered fund as its beneficial owners for purposes of the Section 3(c)(1) requirement limiting beneficial owners to not more than 100 persons.

4. Assuming a registered fund does not "control" the hedge funds in which it invests, the hedge funds will generally not be subject to any of the provisions of the 1940 Act. (Under Section 2(a)(9) of the 1940 Act, control is presumed when a company owns more than 25 percent of the outstanding voting securities of another company).

5. However, the affiliated transaction prohibitions of the 1940 Act can become applicable to a hedge fund that has accepted investments from a registered fund.

   (a) Under Section 2(a)(3) of the 1940 Act, ownership by the registered fund of five percent or more of the outstanding "voting securities" of the hedge fund would cause the registered fund and the hedge fund to be affiliated persons of one another. Affiliation could also arise in other ways. Most importantly, if the adviser of a registered fund manages funds (whether or not registered) and other accounts that, in the aggregate, own more than five percent of the voting securities of a hedge fund, the hedge fund could be an affiliated person of an affiliated person of the registered fund.

   (b) If the hedge fund is an affiliated person of a registered fund (or an affiliated person of such person), Section 17(a) of the 1940 Act would generally prohibit the hedge fund from: selling interests in such fund to the registered fund; and repurchasing such interests from the registered fund.

   (c) The term "voting security" is defined by Section 2(a)(42) of the 1940 Act to mean any security presently entitling the owner to vote for the election of directors of a company. However, the circumstances under which interests in a hedge fund should be considered voting securities are unclear. For this reason, registered hedge funds of funds, and other funds and accounts managed by the same investment adviser, irrevocably waive their voting rights to help ensure that their interests in the hedge funds are not voting securities and to allow them to own five percent or more of the outstanding interests in a hedge fund. The SEC staff has not provided any written guidance relating to this practice, but has not objected to these arrangements.

   (d) Even in circumstances where voting rights have been waived or where a non-voting share class of a hedge fund is owned, significant ownership of the outstanding interests in a hedge fund may possibly cause the interests owned by a registered fund, and by funds and accounts managed by the registered fund's adviser, to be *de facto* voting securities.

VI. Other Regulatory Considerations

A. Trade allocations

1. Investment advisers have a fiduciary duty to treat all clients fairly. Thus, advisory firms that manage both traditional mutual funds (or other "long only" accounts) and hedge funds (whether registered or unregistered) need to assure that their policies on trade allocations appropriately address conflicts that may exist as a result of the differing trading strategies of the hedge funds or as a result of the fact that the firm receives greater compensation for managing the hedge funds. The conflict is particularly acute in circumstances where the same portfolio managers have responsibility both for hedge funds and other types of accounts and where investment personnel have a direct participation in revenues the firm derives from managing hedge funds.

2. One way to mitigate these conflicts is to establish information barriers between personnel involved in managing hedge funds and other investment personnel within the firm. However, this is not always feasible or practicable.

3. If information barriers are not established, trade allocation procedures must be implemented to assure that no client accounts are disadvantaged where there are non-pro rata allocations (e.g., the hedge funds purchase or sell a security that is not also purchased or sold by the mutual funds) and to deal with the implications of short sales by the hedge funds (e.g., selling short a security held long by the mutual funds) and other trading practices which might be viewed as unfair to any client (e.g., the hedge funds purchase thinly traded securities shortly after significant sales of the same securities by the mutual funds).

    (a) Procedures should require either: (i) independent approval of specified types of transactions (i.e., approval by someone other than the portfolio manager); or (ii) the preparation by the portfolio manager of a contemporaneous memorandum of the trading decision which sets forth the rationale for the trade and the differing decisions made for different clients.

    (b) Back-end monitoring of trading patterns should be used to identify potentially abusive practices.

4. A firm's trade allocation policies should be disclosed in the adviser's Form ADV, and appropriate disclosure should also be included in a registered fund's prospectus (or statement of additional information) and in hedge fund offering memoranda.

B. Registered hedge fund of funds

1. Fair value determinations: interests in hedge funds are illiquid and market quotations for these securities are not available. As a result, Section 2(a)(41) of the 1940 Act requires that these interests be valued at their "fair value," as determined in good faith by the board of directors of a registered hedge fund of funds. A registered hedge fund of funds will generally have to rely on valuation information supplied by the managers of the hedge funds in which the registered fund invests. Because transparency to the underlying hedge fund portfolios is not always available, the adviser of a registered fund will typically have no independent means of verifying the valuations provided by the hedge fund managers.

    (a) In its report on the *Implications of the Growth of Hedge Funds* (September 2003) (the "Hedge Fund Report"), the SEC staff recommended that the SEC adopt a rule under the 1940 Act prohibiting registered funds from investing in hedge funds unless their boards of directors adopt procedures designed to ensure that interests in hedge funds are valued consistently with the requirements of the 1940 Act.

    (b) The SEC has not proposed the adoption of such a rule.

    (c) However, in connection with its review of 1933 Act registration statements filed by registered hedge funds of funds, the SEC staff has essentially required the adoption of valuation procedures specifically addressing the valuation of interests in hedge funds.

    (d) In 2006, the Financial Accounting Standards Board issued Statement on Financial Accounting Standards ("SFAS") No. 157, *Fair Value Measurements*. This standard, which applies to fiscal years beginning after Nov. 15, 2007, establishes a definition of "fair value" for accounting purposes, sets out a framework for measuring "fair value" and requires additional disclosures in financial statements about fair value measurements. Investments in hedge funds are Level 3 assets under SFAS No. 157 and consideration needs to be given to the inputs used in determining the "fair value" of these investments and the information used in developing those inputs (e.g., impact of lock-ups and side pockets). In addition, financial statements need to show realized and unrealized gains and losses from these investments and beginning and ending balances of holdings.

2. Disclosure of fees and expenses: in the Hedge Fund Report, the SEC staff recommended the adoption of a rule that would improve disclosure of the indirect fees and expenses that are borne by investors when they invest in funds of funds. The SEC implemented this recommendation by amending Forms N-1A and N-2 (which specify the information that is required in registration statements of mutual funds and closed-end funds, respectively) to require prospectus fee table disclosure by registered funds (not solely registered hedge funds of funds) of the estimated fees (both asset-based and performance-based) and expenses of other funds in which they invest. Rel. No. 33-8713 (June 20, 2006).

3. Use of side letters: in connection with making investments in hedge funds and other private investment funds, investors sometimes enter into "side letters" with the fund managers to obtain various rights that are not given to other investors (e.g., more favorable withdrawal rights, reduced fees, transparency and indemnification rights). When the adviser of a registered hedge fund of funds also manages one or more unregistered hedge funds of funds, the use of side letters may raise an issue under Rule 17d-1 under the 1940 Act.

   (a) Rule 17d-1 prohibits an affiliated person of a registered fund (or an affiliated person of such a person) from entering into any "joint enterprise or other joint arrangement" in which the registered fund is also a participant. The SEC staff has taken the position that co-investments in privately placed securities made by a registered fund and other accounts managed by the adviser of the registered fund may be prohibited by Rule 17d-1 unless various conditions are met. *Massachusetts Mutual Insurance Company* (pub. avail. June 7, 2000) ("*MassMutual*").

   (b) The staff took a no-action position in *MassMutual* allowing co-investments in privately placed securities, subject to certain conditions. One of those conditions is a requirement that no term of the transaction is negotiated, other than "price." For this reason, the use of side letters may, in certain circumstances, implicate the Rule 17d-1 prohibition.

   (c) Registered hedge funds of funds must implement appropriate procedures to deal with this potential issue.

C. Regulatory focus on "retailization" and distribution practices

1. In the Hedge Fund Report, the SEC staff stated that it did not find evidence of significant numbers of "retail" investors investing directly in hedge funds.

   (a) The staff recognized, however, that investments in registered hedge funds of funds expose retail investors to hedge-fund-related risks, and it urged the SEC and NASD, now the Financial Industry Regulatory Authority ("FINRA"), examination staffs to be "vigilant" in identifying violations by broker-dealers of their suitability obligations to customers.

   (b) SEC staff concerns relating to registered hedge funds were primarily related to the "downstreaming" of hedge fund risks to retail investors through registered hedge funds of funds (because the hedge funds in which the registered funds invest are not subject to regulation under the 1940 Act). Registered hedge funds that pursue their investment programs by means of direct investments (as opposed to funds of funds that invest in hedge funds) do not raise similar concerns because the investment and other activities of these funds are fully subject to 1940 Act restrictions and requirements.

2. Notice to Members 03-07 (*NASD Reminds Members of Obligations When Selling Hedge Funds*) summarized the obligations of broker-dealers selling hedge funds, including registered hedge funds of funds, to their customers as follows:

   (a) Sales materials: hedge fund-related sales materials must be fair and balanced and must fully disclose risks. (NASD Conduct Rule 2210 — *Communications with the Public* — is applicable to advertising and sales literature relating to registered hedge funds. Among other things, it requires that the content of such materials meet the standards and requirements of Rule 2210 and that the materials be filed with FINRA).

(b) Suitability: FINRA members selling interests in hedge funds must have a reasonable basis for recommending a particular strategy or investment to a customer. Members must make a “reasonable basis” suitability determination regarding each hedge fund they offer to customers based on product-specific due diligence. Members must also make a “customer specific” suitability determination before recommending a particular hedge fund to a customer (as required by NASD Conduct Rule 2310) based on the customer’s financial and tax status, the customer’s investment objectives and such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer. A customer’s specific level of assets does not, by itself, satisfy a member’s obligation to determine customer suitability.

(c) Internal controls: members must have internal controls, including supervisory and compliance procedures, to ensure that sales of hedge funds comply with all relevant FINRA and SEC rules, and must be able to demonstrate compliance with those procedures.

(d) Training: members must train associated persons about the characteristics of, and risks associated with, hedge funds before they allow their associated persons to recommend hedge funds to customers.

3. In recent years, FINRA has conducted examinations of hedge fund sales literature being used by broker-dealers and brought a number of enforcement actions against firms based on their use of sales literature that violated the standards of Rule 2210. FINRA has also conducted examinations of certain broker-dealers to determine if hedge funds (including registered hedge funds) are being sold to smaller retail investors for whom such investments may not be suitable.

Current Developments in the Secondary Market for Fund Interests

I. Generally

A. Secondary sales of fund interests have been active for many years in the private equity fund space. The key players include:

1. Goldman Sachs Private Equity Group;
2. Coller Capital;
3. HarbourVest;
4. Landmark Partners;
5. Lexington Partners;
6. Neuberger Berman;
7. Newbury Partners;
8. Partners Group;
9. Pomona Capital; and
10. Venture Capital Fund of America.

B. The secondary market is important given that private equity fund interests are illiquid in nature and are structured to be long-term investments (the life of a PE fund is generally 10 years+). The secondary market enables investors to sell their interests and unload the related capital commitment to a buyer at an acceptable price, albeit at a discount to current net asset value.

C. Managers benefit from the secondary market because the transactions are generally confidential and match a willing buyer with a willing seller (who may be cash strapped or otherwise unhappy with the fund's operation/investment history). From the buy-side perspective, the most desirable transactions generally involve sellers with liquidity problems, selling significantly funded interests, such that the buyer can better assess future performance.

II. Hedge Fund Interests

A. Secondary buyers are a more recent market entrant on the hedge fund side. Historically, the liquidity provided by hedge funds meant that investors did not have the need to sell their fund holdings at discount prices.

B. However, the financial crisis created substantial quantities of less liquid hedge fund interests as a result of side pockets, synthetic side pockets, suspensions and gates, and a new crop of secondary buyers has arisen to take advantage of these opportunities.

C. Buyers of these interests include firms such as Coller and Origami that are themselves structured as PE funds. Other buyers are distressed players with broader investment mandates.

III. Selected Issues

A. The issues in these secondary transactions are similar in the private equity and hedge context, and include:

1. Publicly traded partnership considerations: a fund that is classified as a partnership for U.S. tax purposes will generally not allow transfers that could result in the fund being treated as a publicly traded partnership ("PTP") taxable as a corporation. Unless a partnership meets the income exception described in the first bulletpoint below, it will take great care to ensure that there is no "secondary market (or the substantial equivalent thereof)" for the trading of interests therein. A fund's involvement in putting together a secondary transaction needs to be carefully monitored. The most common PTP exceptions are the following:

   (a) Ninety percent qualifying income exception (not available for funds that are registered under the Investment Company Act of 1940, as amended);

   (b) One hundred-tax partner safe harbor, unless the offering of interests is exempt from registration under the Securities Act of 1933, as amended, solely because of Regulation S. This test must be met every day of the partnership's tax year

   (c) "Block transfers" (i.e., a transfer by a partner of greater than two percent of partnership capital or profits);

   (d) "Qualified matching service"; and

   (e) Facts and circumstances analysis to ensure that there is no secondary market or the substantial equivalent thereof. Unlike many affiliate or family transfers, a pure secondary transfer between unrelated parties will often be rejected by the fund if the fund cannot rely on any of the preceding exceptions. There may be more latitude for allowing transfers to an existing partner than to a non-partner.

2. Other tax considerations

   (a) Investors may step into unrealized gains. In addition, transfers often force a fund that is taxed as a partnership and that has a net unrealized loss in its positions to operate as if it had a Section 754 election in effect, which can be time-consuming and expensive for a hedge fund holding hundreds of positions, even if the buyer and seller cover the costs.

   (b) There may be a "technical termination" of a partnership if 50 percent or more of the partnership's profits and capital interests change hands in a 12-month period. In limited situations, a fund may need to re-establish particular tax elections (including restarting the clock on depreciating certain depreciable assets), but the termination itself is generally not a taxable event.

3. Matching buyer and seller

   (a) There is often a need to structure a transaction to match appropriate sellers with buyer(s). For example, if a fund must comply with the so-called "25% Test" under ERISA, a non-ERISA seller may not be able to sell to an ERISA buyer. There are other regulatory and tax characteristics that create similar complications. For example, it may not be tax efficient to match a U.S. (taxable) seller and a non-U.S. buyer (or vice versa) because the U.S. seller is typically invested in a U.S. fund and the non-U.S. buyer would typically invest in the comparable non-U.S. fund (if any) run by the same manager. Sometimes the buyer, through affiliates, is able to address all matching issues. Other times, separate, unaffiliated buyers may be used to address this issue. Depending on the facts, the use of a trust structure may address matching concerns so as to avoid the situation where there is excess demand/supply that cannot be matched.

4. Tender offer rules

   When is the transaction a tender offer? Most tender offer factors do not apply to secondary purchases of asset interests. However, a bidder must hold its tender offer open for a period of at least 20 business days (including the date the offer is commenced), and must pay promptly.

(a) There are eight factors, including how many people are being solicited and whether the offer terms are firm.

(b) There are no specific disclosure requirements for these tender offers. Typically the disclosure document for the offer is a summary term sheet with a short-form letter agreement attached that provides a means to accept the offer. The term sheet usually describes the key terms of the offer, including price, amount sought, conditions and settlement mechanics.

(c) Whether or not a secondary purchase is a tender offer, the letter agreement between the buyer and seller typically contains some basic representations and warranties of the parties, often including "big boy" representations from the offeree, in which the offeree acknowledges that it has made its own independent assessment of the risks involved, including that the offeror or the fund may possess material, non-public information regarding the fund and its investments that may not have been disclosed to the offeree (and in some situations, may not have been disclosed to the offeror (see below)). The SEC staff generally looks unfavorably on these types of provisions for public policy reasons. Note, however, that these provisions do not bar an enforcement action because reliance and damages are not elements of a securities fraud claim brought by the SEC.

(d) PTP concerns: a tender offer by a fund that is a partnership for U.S. tax purposes generally should be viewed as an offer for the investor to withdraw all or a portion of its capital account and could follow the fund's normal PTP guidelines regarding withdrawals. A tender among existing partners may also follow similar guidelines. However, an offer by someone who is not currently a partner in such a fund may be difficult to accomplish for a fund that is basing its non-PTP status on the facts and circumstances surrounding the marketability of its interests.

5. HSR

(a) Acquisitions of fund interests may also be subject to Hart-Scott-Rodino. Currently, the lowest threshold for a reportable transaction under the HSR Act is an acquisition that would result in the acquiring "person" holding $68.2 million of voting securities of a corporate issuer. Thankfully, Hart-Scott-Rodino is easier to avoid if partnership interests (or interests in other unincorporated entities, such as LLCs) are being sold.

6. Role of the GP/IM

Sometimes the fund manager chooses not to involve itself in the process of matching buyers and sellers, other than perhaps to share the names of interested parties and to consent to the transfer. In other cases, the manager may want to play a more active role — but this means having some responsibility for ensuring that the parties have equal access to information, subject to contractual restrictions on underlying disclosure obligations in portfolio investments. Often this is through access to a data room (sometimes upon request).

(a) A fund manager needs to be mindful that it remains a fiduciary throughout the process.

(b) Both buyer and seller need to consider potential material non-public information ("MNPI") issues.

(c) If the buyer is the fund or an affiliate of the fund, the MNPI issue is heightened.

(d) Where the fund is taking an active role in the transaction, the fund should seek to ensure that the buyer does not have better access to material info than the fund's potential selling investors — the fund needs to act as a fiduciary and use efforts to protect its investors' interests. Keep in mind investors are making an investment decision to sell (and implicitly whether to hold).

7. ROFOs and MFNs

   (a) Do other investors in the fund have any rights relating to the sale? Consider, for example, rights of first refusal, MFNs and possible prejudice resulting from the transaction.

8. Changes to terms

   (a) Can the manager require changes to fee and liquidity terms as a condition of consenting to the transaction? The answer depends on the terms of the fund documents and applicable side letters, coupled with fiduciary considerations. Generally, the approach taken should be consistent across investors. Similarly, can the manager require sellers to release the manager from all claims/waive all rights as a condition to consent?

9. Restrictions on GP consents

   (a) What other restrictions apply to the manager in considering whether to consent (e.g., lender and other third-party consents; regulatory limits on who can own fund interests under ERISA, FTC, etc.; securities law considerations such as accredited investor, qualified purchaser and '34 Act slot limits)?

10. Limited diligence/market knowledge

   (a) Are the interests sought to be sold large enough to make it worthwhile for a buyer to do due diligence? If not, should the manager take steps to help package multiple interests? The custom of limited diligence in secondaries creates meaningful advantages for those with pre-existing knowledge of the underlying assets.

11. Is the seller released?

   (a) In the private equity context, will the seller be released from its capital contribution obligations? In this regard, additional complexity is presented when the seller hopes to sell less than all of its interest.

12. Fund affiliates as buyers

   (a) Can the fund or a fund affiliate be a buyer? The answer depends on the text of the fund documents and an analysis of relevant fiduciary considerations.

IV. Additional Duties of the Fund Sponsor

A. If the transaction is a tender offer or otherwise involves multiple sellers, the manager needs to consider whether it has a duty.

   1. To seek out multiple buyers:

      (a) The fund must satisfy its fiduciary duties to its investors in connection with the transaction process. However, there is no single blueprint for selecting a buyer.

      (b) Sometimes the fund will select multiple potential buyers to create a competitive process to then select a preferred bidder who is determined to be providing the most value to selling holders. However, this delays providing investors with liquidity and requires having potential bidders willing to invest significant resources in a process that may result in no transaction.

      (c) A fund may determine that it is preferable to negotiate directly with a reputable buyer with a proven track record for successfully completing secondary fund purchases, and focus efforts on that buyer.

   2. One-on-one purchases vs. offers to multiple investors.

V. New Developments

A. In addition to the arrival of new buyers, we are also seeing the arrival of new matching services:

1. Hedgebay;

2. New players arriving per JOBS Act; and

3. The additional publicity made possible by the JOBS Act may make it easier to do these secondary transactions.

VI. Market Conditions

A. Although many of the hedge fund illiquid interests created during the financial crisis have been resolved, there are enough outstanding pieces to create continuing robust demand in the secondary space for the foreseeable future.

1. On the PE side, the cash flow issues faced by pension plans and endowments, plus the divestiture needs created by the Volcker Rule, Basel III and the crisis in European financial markets also creates multiple sellers.

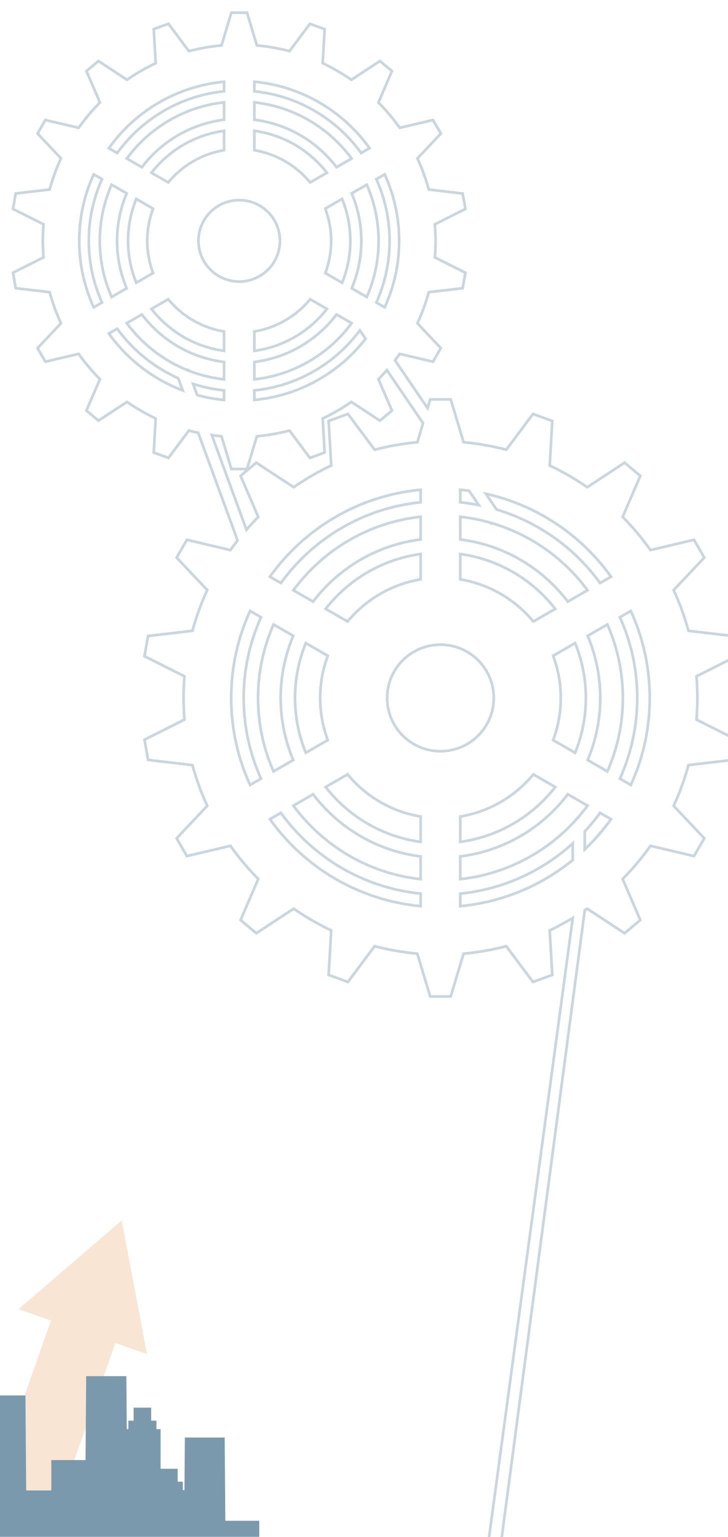
2. As a result, we expect to see a high level of secondary transactions in both spheres.

Schulte Roth & Zabel

Compliance Spotlight

Speakers

Brad Caswell
David Cohen
Marc Elovitz
David Momborquette
Neil Robson



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Brad focuses his practice on counseling hedge and private equity funds on operational, regulatory and compliance matters. He provides guidance to clients on a broad range of issues, including those related to the U.S. Investment Advisers Act, other federal, state and self-regulatory organization requirements and securities trading rules in the United States. Brad also provides guidance to clients with operations in Hong Kong, Japan and other markets throughout Asia and the U.K. with respect to regulatory, compliance, trading and operations.

Prior to joining SRZ, Brad served for 12 years in various in-house roles, including as general counsel and chief compliance officer of investment advisers ranging from multi-billion dollar funds to start-ups, and as a member in the asset management group of a leading investment bank. This in-house experience, coupled with his results-oriented approach to legal problem solving, enables Brad to offer clients a valuable perspective on investment management operations and compliance issues.

Brad is also a frequent speaker and writer on the topics of fund operations and regulatory compliance. He recently spoke on the "New Private Placement Rules Under the JOBS Act" for a Financial Executives Alliance forum, and co-authors a periodic column on hedge fund topics of interest for *HFMWeek*. Recent columns include "The Long View: Why Working Through Every Item on an Extensive Checklist May Obscure the Bigger Risks — Particularly Conflicts of Interest" and "The Long View: How Hedge Fund Advertising Has Been Impacted by the JOBS Act."

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David focuses on matters related to fiduciary responsibility, the Employee Retirement Income Security Act of 1974 (ERISA) and qualified plans.

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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. He recently presented "Distribution Requirements and Taxation" at Practising Law Institute's *ERISA: The Evolving World* seminar, "The Legal Structure of Consultant Arrangements" for the International Foundation Investments Institute and "Structuring a Plan Asset Hedge Fund and Other Current Investment Fund Issues" at the Practising Law Institute's *Pension Plan Investments* seminar.

In recognition of his accomplishments, David has been selected for inclusion in *Chambers USA*, *The Best Lawyers in America* and in *New York Super Lawyers,* a listing of outstanding attorneys in the New York metro area.

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

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Regulatory & Compliance

Hedge Funds

Investment Management

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Marc chairs Schulte Roth & Zabel's Investment Management Regulatory & Compliance Group and advises private fund managers on compliance with the Investment Advisers Act of 1940 and other federal, state and self-regulatory organization requirements, including establishing compliance programs, registering with the SEC and CFTC, and handling SEC and NFA examinations. Marc provides guidance to clients on securities trading matters and represents them in regulatory investigations and enforcement actions, arbitrations and civil litigation. He also regularly leads training sessions for portfolio managers, analysts and traders on complying with insider trading and market manipulation laws, and has developed and led compliance training sessions for marketing and investor relations professionals.

Recently, Marc has been working closely with clients undergoing SEC examinations and responding to deficiency letters and enforcement referrals. He has been developing new compliance testing programs in areas such as trade allocations and conflicts of interest. He also 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.

Marc is a frequent speaker at hedge fund industry conferences and seminars and recently discussed "Increasing Demands for Transparency: Form PF, OPERA, AIFMD" at Deutsche Bank's *Global Prime Finance Hedge Fund Conference* and "Preparing Your Organization for Form PF" at the Goldman Sachs *Fifteenth Annual Hedge Fund Conference*. He addressed "Securities Law Compliance — Insider Trading" at Columbia Business School's *Private Equity* program, "The SEC Exam Process and Compliance Concerns" for the Managed Funds Association's *SEC Compliance Priorities* seminar and "The Challenges of Regulatory Implementation Faced by Private Investment Funds and Their Managers" at the New York City Bar Association. He moderated discussions with staff of the SEC's Division of Investment Management at an ABA Business Law Section meeting and on the ABA webinar "SEC Registration of Investment Advisers."

Marc 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*. He also is the co-author of the "Protecting Your Firm Through Policies and Procedures, Training and Testing" chapter in the *Insider Trading Law and Compliance Answer Book* published by Practising Law Institute, and an article on "The SEC's New Presence Examinations" in the *Investment Lawyer*. Marc is frequently quoted in the media on hedge fund regulation and he authors a quarterly column on hedge fund topics of interest for *HFMWeek*.

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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David focuses on complex commercial litigation and regulatory matters primarily for financial services industry clients, including hedge funds, funds of funds and private equity funds. He 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 work includes representing an inter-dealer broker in certain arbitrations and related civil actions arising from the hiring of brokers by a competitor, advising an investment manager in connection with a fund wind-down and related regulatory and investor disputes, counseling an investment fund in connection with a civil action seeking to enjoin proxy solicitation, representing 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 "Form PF, Form ADV and Form 13H" at UBS's *Premier Hedge Fund Client Conference* and discussed "Recent Developments in US Insider Trading Law and FCPA Enforcement" at an SRZ webinar. He also recently authored the chapter "Big Boy Letters" in the *Insider Trading Law and Compliance Answer Book,* published by Practising Law Institute.

David 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. He earned his B.A. from Boston University.

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Neil 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 merger and acquisition matters.

Neil often appears in publications covering his area of expertise. He was recently interviewed by *Financier Worldwide* for “Preparing for Compliance with the AIFM Directive” and he co-authored “FSA Conflicts of Interest Safeguards: Action To Be Taken by All UK-Authorised Hedge Fund Managers” and “New European Rules on Short Selling — Effective 1 November 2012” for *The Hedge Fund Journal*. He also 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 participated in a “European Short Selling Regulation Panel Discussion” at a J.P. Morgan webinar and participated in an SRZ webinar titled “Spotlight on Compliance and Regulatory Issues.”

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.


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Compliance Spotlight

Notes:


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Notes:

Compliance Spotlight

I. Effectively Managing Your Firm's Compliance Program

A. Annual compliance reviews

1. Rule 206(4)-7 under the Advisers Act: all SEC-registered investment advisers must comply with Rule 206(4)-7. Under this rule, all registered investment advisers must review their compliance policies and procedures to ensure their adequacy and effectiveness. This review must take place no less frequently than annually and be tailored to the adviser's business and strategies and specific compliance risks applicable to the adviser.

   (a) Rule 206(4)-7: "If you are an investment adviser registered or required to be registered under section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3), it shall be unlawful within the meaning of section 206 of the Act (15 U.S.C. 80b-6) for you to provide investment advice to clients unless you:

      (i) Policies and procedures: adopt and implement written policies and procedures reasonably designed to prevent violation, by you and your supervised persons, of the Act and the rules that the Commission has adopted under the Act;

      (ii) Annual review: review, no less frequently than annually, the adequacy of the policies and procedures established pursuant to this section and the effectiveness of their implementation; and

      (iii) Chief compliance officer: designate an individual (who is a supervised person) responsible for administering the policies and procedures that you adopt under paragraph (a) of this section."

2. Due to the need for an adviser-specific review, managers should first identify the relevant risk areas for their firm and any specific compliance weaknesses discovered over the past year and use those risk areas and weaknesses as a starting point for the review. As different firms have different strategies, risks and focuses, the SEC did not include specific steps that must be undertaken as part of an annual review under Rule 206(4)-7. The annual review also should identify and address any relevant changes in laws or regulations that impact the manager.

3. The SEC has never specified what the output or documentation of the annual review should be. Most SEC examiners expect to see a written report that identifies the review process and outcomes in sufficient detail to demonstrate a thorough and effective review. Areas of greater risk for the particular manager should typically be documented in greater detail.

4. The SEC is focusing currently on the following areas — thus, advisers should focus on these areas at a minimum as a jumping off point for a firm-specific tailored annual review.

   (a) Portfolio management: portfolio decision-making practices, consistency with disclosures provided to investors (style drift), allocation of investment opportunities and trading practices.

   (b) Conflicts of interest: allocation of investments, fees and expenses, sources of revenues, payments made by private funds to advisers and related persons, outside business activities, personal trading, and transactions with affiliated parties.

   (c) Insider trading and market manipulation: including use of research consultants.

(d) Safety of client assets: advisers' compliance with the custody rule to prevent the loss or theft of client assets, review of independent audits of private funds for consistency with the custody rule.

(e) Marketing: SEC examination staff are reviewing marketing materials closely to evaluate whether the adviser has made any false or misleading statement about its business or performance record, made any untrue statement of a material fact, omitted material facts or made any statement that is otherwise misleading, or engaged in any manipulative, fraudulent or deceptive activities. The SEC is also reviewing how advisers solicit investors including the use of placement agents.

(f) Valuation: valuation policies and procedures, including methodology for fair-valuing illiquid or difficult-to-value instruments and procedures for calculating management and performance fees and allocation of expenses.

B. Compliance risk matrix and ongoing controls/testing

1. Compliance risk matrix

(a) A risk matrix can be an effective tool to efficiently identify the principle risks applicable to an adviser based on its business and investment strategies and potential weaknesses in the compliance program that merit additional attention and controls.

(b) The CCO should discuss specific compliance risks with the various business units, including portfolio management, trading, operations, finance, accounting, marketing and investor relations, information technology and administration. Specifically, the CCO, together with these other business units, should evaluate how the firm's strategies, activities, arrangements, affiliations, client base, service providers, conflicts of interest, and other business factors may raise potential breaches of fiduciary duty or violations of the Advisers Act or other laws or any appearance of impropriety.

(c) Areas that are identified as contributing to a high risk of compliance violations should receive more attention during the annual review.

2. Ongoing controls and testing

(a) Once the adviser has identified compliance risks or weaknesses, the adviser can address these issues through a more robust compliance program, including policies and procedures tailored to address those risks — but also strong controls/testing of its compliance procedures to ensure effectiveness.

(b) The adviser can implement ongoing and periodic controls to test compliance with its procedures — in particular, the adviser can test the higher risk areas applicable to the firm, such as:

(i) Insider trading;

(ii) Conflicts of interest (including allocation of investment opportunities, outside business activities, personal trading);

(iii) Expense allocations;

(iv) Valuation; and

(v) Marketing.

(c) Methods of testing (ongoing or periodic)

(i) Review of emails and other electronic communications

(ii) Reviewing trade blotter

(iii) Discussions/interviews with employees

(iv) Regular meetings with portfolio management, trading, operations, accounting, finance, marketing, investor relations and information technology

(v) Forensic testing

(1) Restricted list/NDAs

(2) "Outlier" trades

a. Most profitable

b. Atypical issuers/sectors

c. Trading around public company announcements

(3) Gifts and entertainment for particular brokers

(4) Paid research consultants

C. Training

1. General compliance training

(a) Most advisers at a minimum do annual compliance training for all employees where the GC, CCO and/or counsel provides an overview of the compliance manual and code of ethics.

(b) Senior management can demonstrate appropriate "tone at the top" with respect to compliance. This helps set the right example to all employees that compliance is taken seriously.

(c) General compliance training sessions typically cover the firm's compliance manual and code of ethics, including insider trading.

(d) At larger firms, separate and specialized training for different groups of personnel may be appropriate (e.g., traders, analysts, IR, operations, etc.).

2. Additional compliance training sessions

(a) In light of the increased amount of regulation and regulatory scrutiny, most firms should consider multiple training sessions throughout the year.

(b) Topics may include personal trading, conflicts, prohibitions on insider trading, review of marketing materials and the pay to play rules.

3. New employees

(a) Very important that *before* employees start substantive work for the firm, that the CCO do comprehensive compliance training for the new employees.

(b) This is the best time to emphasize the importance of compliance and how seriously the firm takes its responsibilities.

(c) Find out what the employee will be doing and which policies will be impacted and focus on those areas.

II. Selected Current SEC Exam Questions

(Examples to Show Some Specific Items the Exam Staff Is Requiring)

A. Conflicts of interest and/or insider trading

1. The adviser's and affiliates' Code of Ethics and insider trading policies and procedures.

2. Any restricted, watch or grey lists that were in effect during 2012.

3. If not stated in policies and procedures, information about the process used to monitor and control the receipt, flow and use of non-public information, including any restricted, watch or grey lists.

4. Names of any publicly traded companies for which employees of the adviser or its affiliates serve as officers and/or directors, and the name(s) of such employees.

5. Names of companies for which employees of the adviser or its affiliates serve on creditors' committees, and the name(s) of such employees.

6. Any fee-splitting or revenue-sharing arrangements.

B. Fees and expenses

1. Schedule of fees earned by the adviser from each portfolio company. Please list all fees earned for the relevant period.

2. Expense reimbursement policy and guidelines for expenses charged to portfolio companies.

3. Schedule of expenses reimbursed by each portfolio company to the adviser for the relevant period.

4. Please identify any current or former portfolio companies that entered into multi-year fee agreements with the adviser which, upon the sale of the company by the fund, would require the company to pay fees due to be earned by the adviser in the future.

5. For each fund, please provide a list of employees responsible for the review and allocation of fund expenses.

6. Please provide a detailed breakdown of organizational expenses for each fund organized in the five-year period ended ___, 2012, to the extent that those expenses were borne by the funds rather than the adviser.

C. Information regarding the adviser's compliance program, risk management and internal controls

1. Information relating to the firm's compliance testing, including any compliance reviews, quality control analyses, surveillance, and/or forensic or transactional tests performed by the firm. This information should include any significant findings, both positive and negative, of such testing and any information about corrective or remedial actions taken regarding these findings.

2. Ongoing risk identification and assessment

(a) A current inventory of the adviser's compliance risks that forms the basis for its policies and procedures, including any changes made to the inventory and the dates of the changes.

(b) Any documents maintained that map the adviser's inventory of risks to its written policies and procedures.

(c) Any written guidance that the adviser has provided to its employees regarding its compliance risk assessment process and the process for creating policies and procedures to mitigate and manage its compliance risks.

3. Any internal audit review schedules and completed audits including the subject and the date of the report.

4. Information about the oversight process the adviser uses for any remote offices and/or independent advisory contractors, and any policies and procedures with respect to such oversight.

5. Documentation maintained regarding any forensic or other reviews conducted of the adviser's policies and procedures, including any related annual and/or interim reports.

6. A record of any non-compliance with the adviser's Code of Ethics and of any action taken as a result of such non-compliance.

7. Valuation

(a) Names of all pricing services, quotation services, and externally-acquired portfolio accounting systems used in the valuation process and information about whether they are paid in hard or soft dollars, or a combination.

(b) Names of all fair-valued and any illiquid securities held by private funds, a description of any fair value process employed including any testing and results and all fair value reports prepared or reviewed by a valuation committee or other relevant committee.

(c) Supporting documentation for the most recent advisory fee calculation, including management and performance fees and the manner in which the fees were calculated.

III. AIFM Directive — EU Short Selling Regulations — FSA Conflicts of Interest

A. AIFM Directive update

1. Summary

(a) 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.

(b) The AIFM Directive will regulate:

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

(ii) Any non-EU manager managing an EU AIF; and

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

2. Marketing rules applicable from July 22, 2013

(a) At present — national private placement rules and exemptions ("NPPRs") must be used.

(b) From 2013 to 2015:

(i) NPPRs must be used (where these exist in the relevant EU countries);

(ii) Cooperation and information-sharing agreements must exist between: (1) the SEC and the regulator of each EU country into which the marketing is to take place; and (2) the regulator of the country where the fund is established and the regulator of each EU country into which the marketing is to take place. These agreements are currently being negotiated by the European Securities and Markets Authority;

(iii) The third country where the fund is established must not be listed as a non-cooperative state (for money laundering purposes) by the Financial Action Task Force ((b) and (c) together being the "third country requirements"); and

(iv) The fund must publish an annual report and make the appropriate disclosures to investors and regulators, as is required by the AIFM Directive.

(c) From 2015 to 2018, either:

(i) NPPRs must be used, the third country requirements must be satisfied and disclosures made (as in (2) above); or

(ii) The U.S. adviser must become registered with or authorized by the regulator of the EU country in which it intends to conduct the majority of its marketing and would thereby gain a pan-European marketing 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 also have signed an agreement with the EU country where the marketing is to take place as regards the sharing of information for tax matter.

(d) From 2018, there is potential for the NPPRs to be abolished in all countries of the EU, leaving only registration (and compliance with the requirements set forth in 3(b) above as the sole option for non-EU advisers to market their fund(s) into the EU).

B. Pan-EU short-selling regulation

1. Securities

(a) On Nov. 1, 2012, a new harmonized and unified pan-European short-selling regime came into force in all 27 countries of the EU; short-selling rules are now essentially the same in all EU countries.

(b) The rules require any holder of a net short position in a European listed stock exceeding 0.2 percent of the relevant company's issued capital to report that position to the regulator of the EU country where the company is listed with further disclosures at additional 0.1 percent thresholds (i.e., disclosures are required at 0.2 percent, 0.3 percent, 0.4 percent, 0.5 percent etc.). The regulator will make the report public on its website where any position disclosed exceeds 0.5 percent. Downward disclosures are also required when a net short position is decreasing.

(c) The new rules prohibit "naked" or uncovered short sales; at the time a short sale is entered into, the person entering into the position must have borrowed, agreed to borrow or otherwise secured a location for the relevant securities.

(d) All previous national rules on short selling that existed with respect to EU countries have been superseded by the new pan-European rules (although Austria exercised its right to defer the new rules until July 2013, meaning that its pre-existing rules continue until then, after which the new rules will become effective).

(e) National regulators will still be permitted to impose a three-month ban on short-selling in domestic markets (such as that put in place by Spain on Nov. 1, 2012), but only where justified. Significantly, the rules also give the

European Securities and Markets Authority the power to impose a ban on short-selling across the whole of the EU in emergency circumstances.

2. EU sovereign debt

(a) The new rules also include requirements relating to EU sovereign debt issued by EU member states, the EU itself, the European Financial Stability Facility and the European Investment Bank. The rules also include credit default swap ("CDS") positions referable to EU sovereign debt as this is deemed to be equivalent to a short sale for EU purposes.

(b) Private disclosures must be made to the relevant regulator of the country concerned at:

(i) 0.1 percent, where the total amount of the outstanding sovereign debt is less than €500 billion, with incremental disclosures required to be made at each 0.05 percent thereafter on an increasing and decreasing basis; and

(ii) 0.5 percent, where the total amount of the outstanding sovereign debt is €500 billion or greater (or where there is a liquid futures market for the particular sovereign debt), with incremental disclosures required to be made at each 0.25 percent thereafter on an increasing and decreasing basis.

(c) Short sales of EU sovereign debt must also be covered, and CDS positions referable to EU sovereign debt must serve to hedge against a long position of assets in the relevant country where the CDS position serves to hedge against the risk of default of the issuer(s) or a risk of decline in value where the value of those assets is highly correlated to the value of the sovereign debt and the CDS position is proportionate to the risks it is hedging against.

C. U.K. Financial Services Authority ("FSA") report on conflicts of interest

1. FSA conflicts of interest rules

(a) FSA rules impose a fiduciary standard on U.K.-authorized managers and require that when making investment decisions or buying products and services for customers, such managers must act in their customers' best interests and put their customers' interests ahead of their own. In particular, an FSA-authorized hedge fund manager must first take "all reasonable steps" to identify and record any conflicts of interest between itself and its customers or between one customer and another. Once conflicts are identified, hedge fund managers must, assuming the conflict is not a fundamental conflict that would require the firm not to act or to cease acting, take all reasonable steps to properly manage any such conflicts of interest so as to prevent them from constituting or giving rise to a material risk of damage to a customer's interests. Where these measures are not sufficient to ensure, with reasonable confidence, the protection of the customer, the investment manager must make effective disclosures before undertaking business for a customer.

(b) Between June 2011 and February 2012, the FSA performed "thematic reviews" of a number of FSA-authorized investment managers and found that in many cases senior management failed to demonstrate to the FSA a culture that was sensitive to conflicts of interest had been embedded in their firm and consequently that those firms did not have organizational, technological and procedural mechanisms to identify, challenge, mitigate and disclose conflicts of interest. The FSA's report focused on its findings in the reviews.

2. Specific areas of concern noted by the FSA

(a) Dealing Commission/soft dollars

(i) The FSA made it clear in the report that it wants to see firms giving thought to tailored and appropriate systems and controls designed to protect customer interests with regular internal reviews by the firm's governing body. The report also highlighted the issue of the "unbundling" of services being paid for with soft dollars — with fund managers being placed on notice that any use of commissions to pay for services requires an allocation of such fees among execution, research and other services — with a proportionate allocation; U.K. hedge fund managers will have to be prepared to explain and defend any allocation methodology to the FSA.

(b) Gifts and entertainment

(i) The report noted that few reviewed investment managers had considered how accepting gifts and entertainment could compromise their duty to act in their customers' best interests. Hedge fund managers should review their policies to ensure that the giving or acceptance of gifts or entertainment could not give rise to cause for concern about the objectivity of decisions taken.

(c) Allocation of investment opportunities

(i) FSA rules require prompt and accurate recording, allocation and documentation of trades with hedge fund managers being required to maintain a clear and documented allocation policy. Trade allocations should be made between the investment manager's customers contemporaneously with the execution of the relevant trade(s) (or as close thereto as is feasible). In the event that an allocation is not contemporaneously made or is not allocated in a timely manner after the trade is executed, there should be a record made in the firm's compliance files as to why the manager considers:

(1) The deviation from the policy to be in the best interests of the customers involved; and

(2) That no customer suffers any detriment as a result of the allocation. If a manager engages in cross trades among customer accounts, the manager should be able to demonstrate that it has controls in place intended to ensure that the transaction is at a fair price.

(d) Employee personal account ("PA") dealing

(i) The report highlighted examples of what the FSA considers good practice in this area:

(1) Establishing a requirement to educate and train employees on the conflicts of interest that can be created by PA dealing;

(2) Drafting written policies that set out clear PA dealing procedures;

(3) Enforcing policies and procedures that impose significant PA restrictions (the FSA cited as examples a "long-term investor"/minimum holding period requirement and an upper limit on trading frequency);

(4) Monitoring PA dealing activity, and performing targeted reviews on the PAs of staff engaged in extensive personal trading or who are judged to be in particularly sensitive roles; and

(5) Empowering a governance committee to oversee PA dealing activity and periodically to review other aspects of the policy to help ensure it remains appropriate.

(e) Trade errors

(i) The report was particularly focused on the reliance by hedge fund managers on gross negligence clauses to reduce their liabilities for the costs of trade errors and omissions. While the FSA did not state that “gross negligence” is not appropriate in this area, it did indicate that it has some concerns about reliance on these clauses to justify not reporting trade errors to customers or not collecting error-related information. The FSA commented that it felt that the firms in its review that used this standard had not considered whether repeatedly making the same or similar errors might in itself amount to gross negligence. The FSA endorses a policy that allocates losses (to the investment manager) and gains (to the customer) from trade errors, with certain exceptions, but this position remains an FSA preference and not a requirement.

3. Concerns for U.K. affiliates of U.S. managers

(a) The report highlighted concerns that the FSA has with authorized managers in the U.K. that are part of a larger global organization. The FSA cited concerns related to governance and organization and noted that in some cases:

(i) The U.K. board did not exercise sole or “meaningful control” over the authorized manager’s conflicts management and other compliance responsibilities; and

(ii) Individuals based overseas at the parent entity were making decisions on the investment manager’s core practices. Those U.S. investment advisers with FSA-authorized affiliates in the U.K. would be advised to review the U.K. entity’s policies and procedures to ensure that an appropriate senior person in the U.K. effectively takes actual responsibility for compliance with the FSA’s rules.

IV. ERISA

A. Individual Retirement Accounts as investors — general

1. We are seeing a significant increase in calls related to investments that were supposed to have been made from IRAs, but instead turn out to be personal investments because of faulty communication between investors and the IRA custodians.

2. If the IRA custodian has not signed the subscription agreement, the chances are good that the IRA custodian wired money out of the IRA as a distribution, rather than treating the investment as an investment of the IRA.

3. When this happens, the IRA custodian will have tax reported the investment as a distribution from the IRA, issuing a Form 1099-R to the IRS and the IRA holder. However, the investors typically ignore this form and the IRS program that matches Form 1099-R with the taxpayer’s tax return often overlooks the fact that the taxpayer did not report the distribution on his or her tax return.

4. By law, only banks (including free-standing trust companies), insurance companies and approved non-bank custodians (i.e., broker-dealers) can serve as IRA custodians. Hedge funds cannot serve as an IRA custodian under any circumstances, nor can offshore administrators.

5. Because a hedge fund cannot serve as an IRA custodian, it should never take money from or pay out money to the individual investor. All cash flows should be from and to the IRA custodian.

6. In theory, a hedge fund should not be responsible for the error of what was supposed to have been an IRA investment turning out to be a personal investment of the individual. However, we often see emails and other communications that could be interpreted to say that the hedge fund can serve as the IRA custodian. In addition, in problem situations, we often find IRA subscription agreements that were signed exclusively by the individual, either with the custodian signature page left

blank or with the individual having signed the custodian signature page with his or her name.

7. In light of these concerns, we suggest a review of all IRA investors to ensure that each IRA investment has been signed by an IRA custodian or that there is some other evidence that the custodian recognizes the investment in the hedge fund as an IRA investment. New subscriptions from IRAs should be very carefully reviewed internally to ensure that a custodian has signed the subscription agreement.

8. ERISA treats IRAs as benefit plan investors. Accordingly, their money counts as "bad" money for the 25 percent test. The subscription agreement should be filled out accordingly.

9. Where the IRA custodian is a broker-dealer, the custodian may request the manager to sign a "good control location" letter on the basis that this is required by SEC rules. These letters should not raise significant issues other than for the requirement that the fund deliver pricing information early in January. This request is driven by IRS rules that require the IRA custodian to issue a form to the IRS showing the fair market value of the IRA by the end of January.

10. Trust companies do not require a similar "good control location" letter because they are not subject to SEC oversight. They are, however, subject to the same IRS annual reporting rule.

B. Investment in the hedge fund by employee/partner IRAs

1. Employees and partners can invest in their own hedge fund, but they must do so on a fee-free basis. Charging fees can result in the disqualification of the IRA, rendering the entire investment taxable.

2. Some custodians have begun to insist that the IRAs of family members not be charged fees in the absence of an opinion of counsel that the charging of fees does not give rise to a prohibited transaction.

3. Some custodians are requesting opinions of counsel whenever an employee or partner invests his or her IRA in the fund. We have resisted issuing such opinions as an unnecessary expense.

C. Investing the hedge fund manager's 401(k) plan in its own fund

1. As early as 1975, the DOL recognized that a money management firm can invest the assets of its pension plan and does not need to hand over the assets to an unrelated party.

2. The one caveat is that management must be done on a fee-free basis.

3. Because the plan, and not the individual employee, is the investor, the fee-free basis must continue even with respect to individuals who invested through the plan but are no longer employees or partners.

4. In the self-directed 401(k) plan context, the SEC treats the plan of the hedge fund manager as a single investor if the hedge fund is a 3(c)(1) fund. Thus, all of the employees can elect to invest in the hedge fund, regardless of whether a particular employee is an accredited investor. This jibes with the Internal Revenue Code anti-discrimination requirement that all plan investment options be available to low-paid as well as high-paid employees.

5. The SEC has not applied the same rule to 3(c)(7) funds. Instead, the rules would look through to each account in the 401(k) plan that invested in the hedge fund. Accordingly, a 3(c)(7) fund cannot be a specified investment option in a 401(k) plan because it would not be available to the lower-paid employees.

6. With careful planning, there are strategies that can allow for investment in a 3(c)(7) fund while still complying with the anti-discrimination rules with respect to investment options in the plan.

D. 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 percent 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 funds-of-funds — proportionate vs. all or nothing: the failure to count by proportions often results 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 percent 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.

E. 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 funds managers that manage plan asset funds-of-funds.

3. It's not correct to say that an over-25 percent 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.

F. 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 percent limitation on benefit plan investors' investment in the fund. Accordingly, many managers are looking for ways in which to increase ERISA capacity without subjecting their hedge fund to the fiduciary responsibility provisions of ERISA.

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 percent limitation on investment by benefit plan investors. However, the master fund, where the capital from all of the feeder funds is aggregated, will be under 25 percent plan assets. Thus, even though the offshore feeder fund is a benefit plan investor, only a portion of its investment in the master fund is counted as benefit plan investor capital. At the onshore feeder fund, little if any investment will have come from benefit plan investors. Thus, no part of the onshore feeder fund's investment in the master 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 percent of the capital in the only class of shares of the master fund, and thus neither the master fund nor its investment manager are subject to ERISA.

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 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 percent limit as long as the master fund is kept under 25 percent of 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 funds of funds would not invest in a plan asset fund. Many of those funds of funds have accepted that investing in a "hard wired" master-feeder structure in which the master fund is not a plan asset vehicle complies with the fund of funds' promise to its ERISA investors, though not all. In those situations where a fund of funds that is a benefit plan investor is not willing to invest in a "hard wired" offshore feeder fund that is over 25 percent plan assets, we recommend that an ERISA-only offshore feeder fund be set

up to accommodate the existing ERISA investors that are willing to make the switch as well as for new ERISA investors. Those ERISA investors that state that they may not invest in a plan asset vehicle would remain in the original offshore feeder fund, which continues to be below the 25 percent ERISA threshold and thus is not a plan asset vehicle. A second issue that arises from ERISA investors involves the fidelity bond mandated by ERISA for anyone who "handles" pension money. Whether the manager of the offshore feeder fund needs to obtain the fidelity bond and who pays for the bond are the subject of negotiation. ERISA would permit the ERISA investor to cover the manager of the offshore feeder fund as an agent on the ERISA investor's own fidelity bond, but plans and funds of funds that are themselves benefit plan investors are sometimes resistant to doing this. If the manager of the offshore feeder fund agrees to obtain the fidelity bond, ERISA would permit the offshore feeder fund to pay the premium, but here, too, resistance is sometimes encountered from ERISA plans and other benefit plan investors.

G. New DOL rules

1. A new ERISA Section 408(b)(2) regulation that governs the receipt of compensation became effective this past summer.

2. The DOL issued final regulations implementing the statutory prohibited transaction exemption that allows pension plan investment managers to be paid.

3. The final regulation has no impact on non-plan asset funds, but does impact plan asset funds.

4. The final regulation provides disclosure rules regarding manager compensation, conflicts and soft dollars.

5. The typical offering memorandum for a plan asset fund, along with the monthly statements and the annual audited financials, most likely comply with the disclosure rules in the final regulation.

6. However, soft dollar disclosure is an open issue and the final regulation sheds no light on this issue.

H. 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 bipartisan 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" and have listed the re-proposal as a regulatory priority for 2013.

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.

I. Form 5500

1. Not many plans make Form 5500 requests; it's mainly just the larger plans but we are seeing more requests.

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.

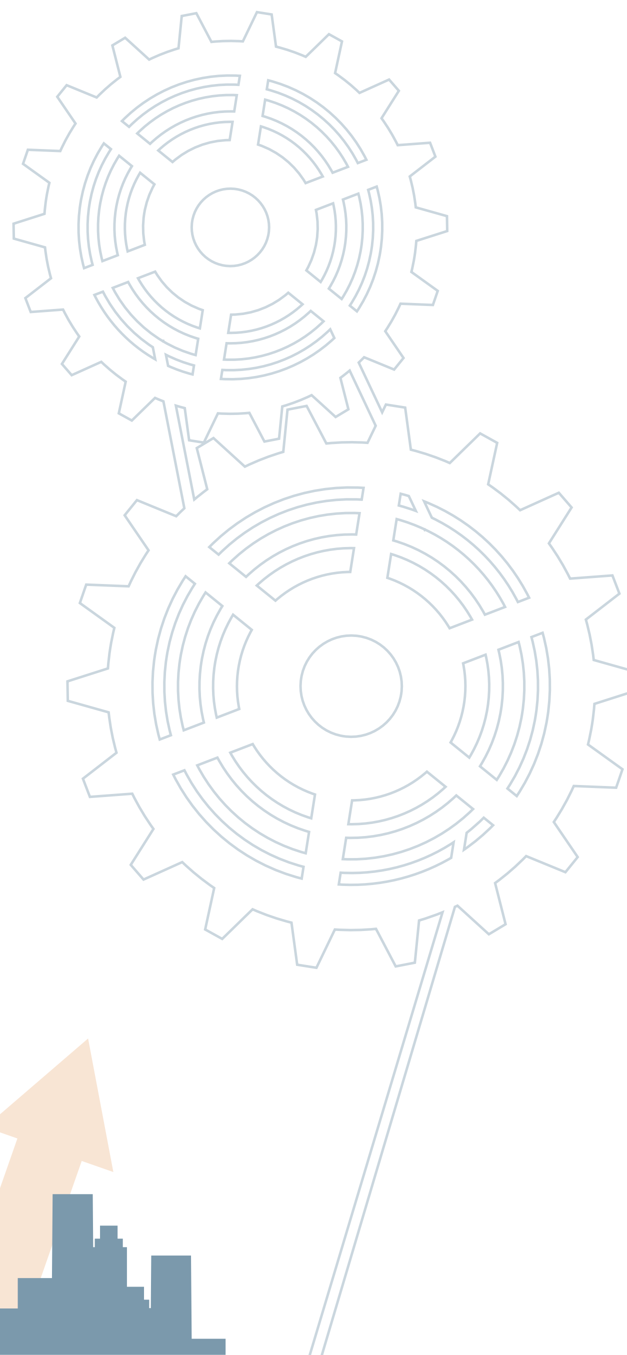
8. The DOL divides soft dollars into two categories: proprietary soft dollars versus soft dollar bank accounts, and requires different reporting for each category.

Schulte Roth & Zabel

Manager Acquisitions and Spinoffs

Speakers

Philippe Benedict
Christopher Harrison
Richard Presutti
Joseph Vitale
Holly Weiss



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Philippe focuses his practice on the tax aspects of investment funds, mergers and acquisitions, international transactions, real estate transactions and financial instruments.

Philippe has advised on many major transactions involving sales or spinoffs of investment fund managers, and advised Prisma Capital Partners in its acquisition by global investment firm KKR & Co. Philippe's other recent representations include: advising Scopia Fund Management LLC in its sale of a passive minority interest to Neuberger Berman Group-managed private equity fund Dyal Capital Partners; advising MKP Capital Management LLC on an investment by Dyal; generally advising Mount Kellett Capital Management LP on the tax structuring of its worldwide investments; representing Toronto-based Oxford Properties Group in connection with its joint venture with Related Companies for the development, leasing and funding of Hudson Yards; and advising multiple alternative asset managers on the formation and structuring of many funds during the past year.

A frequent speaker at prominent industry events, Philippe recently spoke on "Best Practices in Succession Management" at the Managed Funds Association's *Key Components of Building a Succession Plan for Your Hedge Fund* seminar, "FATCA and Dividend Equivalent Withholding Developments" at an SRZ *Investment Management Hot Topics* program and "How Will New Tax Changes Affect Hedge Funds in 2012?" at Bank of America Merrill Lynch's *Deciphering the New Regulatory and Tax Environment seminar*.

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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Chris specializes in hedge fund mergers and acquisitions. Chris's recent representations include advising a global bank on its acquisition of a significant non-controlling economic interest in a hedge fund manager, advising a global bank in its proposed divestiture of a private equity business, and advising a fund of funds manager, a high frequency trading hedge fund manager, a long-short credit fund manager, a global macro fund manager, and various other fund managers in the sale of control of their businesses to various buyers.

Prior to becoming a partner, Chris was selected as the only associate in the U.S. for the BTI's Client Service All-Star Team. Chris frequently speaks and writes on his areas of expertise. In addition to teaching a popular mergers and acquisitions course as an adjunct professor at NYU, he has chaired a panel on cross-border transactions and authored multiple articles on merger and acquisiton deal structures, takeover tactics and change-of-control issues for various *Bloomberg Law Reports* and *The Hedge Fund Journal*. Chris is currently under contract with Bloomberg to write the upcoming book *M&A Legal: Understanding and Negotiating Transactions*.

Chris earned his J.D., *cum laude*, from New York University School of Law, where he was senior articles editor for the *Journal of International Law and Politics*. He received his B.A. from Friedrich-Schiller-Universität.

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Rick practices primarily in the areas of private equity, mergers and acquisitions, leveraged buyouts and alternative asset management transactional matters.

Rick regularly represents a number of private equity clients, including Levine Leichtman Capital Partners, Marlin Equity Partners, Cerberus Capital Management, Black Diamond Capital Management and Veritas Capital.

Rick represented Chrysler Financial in its sale to TD Bank, a transaction named ACG Cross Border Deal of the Year and M&A Atlas Financial Services Deal of the Year, and Chrysler in its sale to the Fiat-led group, a transaction that received the M&A Atlas Deal of the Year award.

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

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Joseph represents financial institutions with respect to: chartering; regulatory compliance; financial transactions; mergers, acquisitions and reorganizations; responses to formal and informal regulatory actions; litigations and claims and legislative and regulatory developments. Joseph also advises parties, including private investment funds, seeking to acquire banks or other licensed financial service providers. He practices before the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Federal Housing Finance Agency and the banking agencies of all 50 states, the District of Columbia and Puerto Rico. *Chambers USA* recognizes Joseph as one of the nation's leading lawyers for both banking compliance and financial institutions M&A work, noting that clients give him "strong reviews for his broad regulatory practice," particularly his "substantive technical knowledge and good advocacy skills."

Highlights of Joseph's practice include his representation of the majority owners of a Fortune 500 mortgage and consumer finance conglomerate in connection with the institution's conversion into the nation's 14th largest bank holding company, a complex transaction that included a related $2 billion private recapitalization and the acquisition of $5 billion in public funds through the TARP; and his representation of both the seller (a private investment firm) and the buyer (one of the 15 largest banks in the U.S.) in the $6.2 billion sale of a national consumer finance company, including obtaining more than 100 government approvals necessary to close the transaction. Other practice highlights include advising the nation's largest Internet retailer on the creation of its online money transmission and payments business.

Joseph is admitted to federal and state courts for the District of Columbia and the State of New York, as well as the U.S. Court of Federal Claims, where, among other matters, he co-litigated a breach-of-contract claim on behalf of a former thrift institution which, after an eight-week trial, resulted in a $96 million judgment against the U.S. government.

Joseph frequently speaks on current topics of interest to banks and other financial institutions. He recently discussed "Strategic M&A in the Financial Services Industry" at the mergermarket *3rd Annual Financial Services M&A Symposium* and "Providing Legal Guidance in an Uncertain Federal Regulatory Landscape for Emerging Payment Systems" at the ACI *4th National Emerging Payment Systems Conference*.

Joseph received his J.D. from Georgetown University Law Center in 1997 and his A.B. from the College of the Holy Cross in 1994.

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

Holly has authored or co-authored numerous articles of interest to employers, including “Alternative Dispute Resolution in the Executive Employment Context,” which appeared in *BNA’s Executive Compensation Library on the Web*. She has addressed pressing employment, compensation and related issues for many professional associations, including the MFA General Counsel Forum, the New York State Bar Association Labor and Employment Law Section and the NASD Institute for Professional Development.

Holly is recognized as a leading practitioner in her field by both *The Best Lawyers in America* and *New York Super Lawyers*.

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

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Manager Acquisitions and Spinoffs

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Manager Acquisitions and Spinoffs

I. Market Updates

A. Worldwide, the number of asset management M&A deals was up in 2012 compared to 2011 by approximately 10 percent. (By that, we are referring to transactions in which equity stakes in the management company and/or general partner of an asset management business is sold.)

B. By region, that growth was driven by an uptick in deals in each of North America, Europe and South America. Only Asia saw a decline in deal making.

1. The growth in U.S. deals was concentrated in the fourth quarter, likely due to the anticipation of an increase in U.S. capital gains tax for transactions closing in 2013.

2. In contrast, European and South American growth was spread throughout the year.

C. By seller, that growth was driven by an increase in the number of divestitures by banks and the continuing consolidation of stand-alone asset managers.

II. Banks as Sellers/Buying From a Bank

A. Although banks have done some buying, banks are on the whole net sellers of asset management businesses in this economic and regulatory environment.

B. Deal drivers

1. The role of Volcker: under the Volcker Rule, banking entities will need to cease most proprietary trading activities and divest most proprietary interests in investment funds by July 2014. The eventual restriction on proprietary trading has caused numerous proprietary trading teams to leave banking entities (including to form their own funds or join existing asset managers). Such occurrences are likely to continue as we approach the Volcker Rule's effective date and banks are forced to stop such trading.

   In contrast, the Volcker Rule does not restrict the ability of a banking entity to continue to engage in asset management for third parties. Thus, the Volcker Rule does not motivate banking entities to sell asset management businesses, nor is it, by itself, a reason for asset management personnel to want to leave a banking entity.

2. Changing tax rates: as corporate tax rates are not expected to increase, corporate sellers are less driven by tax than management sellers.

3. Dodd-Frank: unlike the Volcker Rule, other parts of the Dodd-Frank Act do provide an incentive for a banking entity to want to divest an asset management business or for managers to want to leave.

   (a) Capital requirements: under the Dodd-Frank Act (as well as the Basel III Accord), banking entities are subject to more stringent capital requirements. As a result, many banking entities will need to sell off non-core businesses, including asset management businesses, to shore up their balance sheets and increase their capital ratios.

   (b) Compensation rules: under the Dodd-Frank Act, banking entities with more than $1 billion in assets are prohibited from paying any incentive-based compensation that is deemed to be "excessive" or to encourage undue risk-taking. Asset management personnel may want to leave a banking entity to avoid being subject to these compensation restrictions.

C. Terms and challenges we are seeing in these deals

1. Pressure for up-front cash: for many reasons — including the Basel III capital, leverage-ratio and liquidity requirements[1] — banks are generally seeking to sell interests in fund managers (and related proprietary commitments) for cash.

2. Fewer earnouts: for similar reasons as above, banks are showing less tolerance for the uncertainty of earnouts and a greater appetite for up-front cash.

3. Sale of LP stakes; sale of existing carry (value and control issues). Again, when a bank holds LP interests in a fund on its balance sheet, there are external pressures to realize the value in cash to aid with Basel III regulatory capital compliance. Furthering the necessity to divest such interests, upon Volcker implementation, a bank will not be permitted to invest in a third-party fund. As a result, banks will eventually need to divest any LP stakes in the funds of divested managers.

   (a) As a process matter, the sale of the LP stake is consistent with expectations of third-party investors (whose consent is needed for a transaction of this sort). Those investors are happy to see the acquirer will have skin in the game on a going-forward basis. Third-party investors tend to be indifferent to a sale of existing (but unrealized) carry.

   (b) The allocation of a purchase price in such a deal to LP stakes and existing carry, in addition to the business itself, however, presents real valuation issues.

4. Banks are less interested in holding continuing equity stakes than management-sellers. For some counterparties, the compliance burdens of having a bank continue as a partner creates incremental regulatory burdens. For banks, holding equity means less up-front cash realization.

5. As a result of fewer earnouts and less retained equity by sellers in such deals, there is less of a struggle by sellers to have continuing control rights after closing.

D. Management considerations

1. Motivating management participation in the sale process when management does not hold equity: buyers and sellers should consider long-term employment agreements with management, with carrots (incentive compensation, bonus plans and deferred compensation tied to continued employment) and sticks (restrictive covenants, forfeitures/exposure to breach of contract claims for terminating employment).

   (a) The Carrot ...

   Compensation for retention packages and pre-agreed future bonus plans:

      (i) In traditional asset manager deals, management is often composed of the selling equity holders. In bank deals and other financial institution deals, management is composed of employees. As such, in bank deals, management likely does not have the financial upside of an equity holder, so the parties need to find another way to motivate management to engage in the transaction.

      (ii) GAAP issues: payment of a portion of the purchase price to management as a “bonus” purchase price could convert purchase price into a GAAP expense for the buyer.

      (iii) 409A issues: any “bonus” purchase price will need to be structured so as to comply with the deferral rules of Section 409A of the Code.

[1] While the exact requirements of Basel III for U.S. banks is not yet known, and even for non-U.S. banks is subject to change (as evidenced by the recent changes to the liquidity requirements), its requirements will be more stringent than those replaced.

(iv) Future retention as reflected in projections may affect price.

(b) ... and the Stick

Retention achieved and bolstered through:

(i) Long-term non-competes: non-compete agreements, with a term that applies for several years after the transaction, are often used as a tool to discourage departures. The duration of the non-compete is often tied to earnout period, if there is one.

Outside of the sale-of-business context, restrictive covenants are enforceable only if reasonable in scope and duration and only to protect an employer's legitimate interests (e.g., trade secret information). 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. Machs. 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)). Retention is not a legally protectable interest.

(ii) Restrictions on the use of confidential information by management and broad clarifications as to what constitutes work product owned by the manager: by drafting such provisions very broadly, some managers are able to obtain incremental restrictions on the ability of management to compete after departure. Even when these provisions are too broad to be enforceable, the threat and risk of litigation can influence management to avoid competing with the manager.

(iii) Track record terms: these provisions specify that management has no right to use the track record of the funds they were managing after departure from the business. In that case, it is more difficult for a manager to start his or her own fund and compete, because the manager would not have the benefit of demonstrating a track record to potential investors.

(iv) Other creative methods: some managers have introduced springing equity stakes in which the management company obtains a seed-capital-like stake in any future business started by a departing manager. Put/call arrangements can also force a departing manager to acquire equity at undesirable prices, which also provides an incentive not to depart.

2. Unlike earnouts for sellers, retention packages can be conditioned on employment. When management-sellers receive earnouts, they desire for those earnouts to be treated as purchase price (capital gains) for tax purposes. In order to ensure that such treatment is preserved, receipt of the earnout cannot be conditioned on the seller continuing his or her employment with the target business after it is sold to a buyer. However, in the context of a bank or other corporate seller, management is not selling equity. Retention payments received by management constitute ordinary income for tax purposes in any event, so conditioning those payments on continued employment does not result in worse tax treatment for management.

III. Consolidation of Fund Managers

A. Fund managers are themselves the largest buyers of asset management firms currently. This evidences the continuing consolidation of the industry.

B. In some cases, the consolidation is driven by asset managers seeking to diversify their sources of revenue. This is sometimes done in anticipation of a potential IPO by large, diversified asset management firms.

IV. Spin Outs

A. The number of management buyouts of their own firms has remained relatively stable in 2012, growing slightly over 2011.

B. Pricing structures

1. The largest constraint on management buyouts is management's ability to obtain the capital to fund the buyout. Credit is still constrained for such buyers. And alternative sources for funding such acquisitions — such as offering a continuing equity stake in the management company being spun off and deferring compensation through earnout arrangements — is less desirable to some of today's sellers because they are more heavily focused on up-front cash consideration than in prior years. However, in a spin out when no purchase price is paid to the "seller," such a "seller" will retain some revenue stream through retained equity in the management entity and/or carry vehicle. Such equity is often structured as a pre-tax allocation.

2. Nevertheless, management has leverage to buy their own management companies from corporate/bank sellers. Management is key to being able to sell any asset management business. If management is seriously pursuing a buyout, it can be difficult for a seller to resist management's desires and seek other buyers who may not want to buy into an unhappy management team.

C. Release of management from restrictive covenants

1. In spin outs, management wants a full release from all restrictive covenants (non-competes, non-solicits) and to receive all deferred compensation regardless of restrictions.

2. Seller wants to release only to the extent necessary to permit management to move forward successfully in the contemplated business and to protect itself from breaches.

3. Resolution is usually highly negotiated — e.g., management released from employee non-solicits with respect to particular employees; management released from non-compete for particular business; remedies for breach negotiated — and sometimes limited.

D. Use of track record

1. Management will negotiate for a right to unrestricted use of its own track record as part of a spin out transaction. Management will also negotiate for the seller to forego any rights to also use that track record.

2. Managements also will negotiate to obtain the underlying documentation to support the track record."

E. Continuing relationships with sellers (prime brokerage, distribution, etc.)

1. Because a spin out by definition creates a new, small company, that company will have a need for all the outside services that are required to run and grow the business, such as prime brokerage and distribution services.

2. Service arrangements with the seller are often negotiated as part of the deal. This can allow the seller to lock in a future customer and revenue stream. It can also allow a new asset manager to start out with a distribution source that it is happy with.

V. Majority Deals

A. The number of majority, or "control," deals showed a meaningful uptick in the last quarter of 2012. Control and non-control deals happen for all sizes of asset managers, but on the whole, control deals are more likely for small targets, while larger targets are more likely to sell non-control stakes.

B. The long-term earnout has become the primary method to address valuation and longevity concerns in control deals. Frequently, as much as half of the total anticipated purchase price is paid at closing. The remainder, which may or may not be capped, is based on one or more measures of performance — most frequently, total or average EBITDA or management fees — covering a three- to seven-year period post-closing.

1. Revenue share (above the line): if the earnout is determined based on the amount of revenue, then the incentives of the buyer and the sellers are somewhat aligned, because everyone benefits from more revenue. This alignment of incentives results in less tension in negotiating the terms of the deal, in particular in negotiating the sellers' desire to maintain some continuing control over the target business to help ensure that the earnout targets are met.

2. EBITDA/earnings share (below the line): in many cases, however, the buyer understandably wants to ensure that it has the anticipated profitability — not revenue — before it pays the earnout. Basing the earnout on profitability, however, creates conflicts of interest between the buyer which owns the business and the seller which has its purchase price tied to the profitability of the business. The sellers will want to ensure controls over, or participation in, the process of deciding on annual compensation expense and/or other major cost drivers. The buyer will not want to cede control to a party that no longer owns equity in the business.

C. Next to negotiations over purchase price, including the earnout, dividing up and sharing governance rights is the most challenging and intricate aspect of reaching an agreement in control deals. The competing interests of buyers and sellers typically come together in practice through a complicated set of checks and balances that shift over time with changes in the parties' interests and leverage.

1. The balance of governance rights tends to favor the sellers during the initial earnout stage, even where a majority or 100 percent of the target has been sold to the buyer. Sellers insist on, and frequently attain, a high degree of control over the day-to-day operations and other matters that could impact their ability to obtain the earnout portion of the purchase price. Where the buyer acquires voting control, the sellers will require vetoes over fundamental business decisions to protect themselves from the buyer forcing changes which impact their ability to hit the earnout targets.

2. Where the buyer has acquired a majority of the business, governance typically transitions to the buyer after the earnout period. The sellers relinquish some veto rights, but nevertheless maintain more control than in a typical majority acquisition because of the need to assure investors in target products that the management team they are counting on continues to manage investment matters. As a result, the selling partners continue to run the day-to-day operations, but will no longer have the right to block all decisions of the buyer, if the buyer decides to move the business in a new direction.

D. Restrictive covenants

1. Where the founders of the management company are the sellers, the buyer often seeks long-term non-competes and non-solicitation provisions (as to employees and investors). This is often designed to help ensure that the founders continue to work in the target business, by restraining them from working elsewhere in the same line of work or starting another competing fund.

2. 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 & Assocs., Inc. v. Uniforce Servs., Inc.*, 37 F. Supp. 2d 192, 196-97 (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 Spuck Statewide Supply Co. v. Meyer*, 273 A.D.2d 745 (3d Dep't 2000)

(enforcing 10-year non-compete ancillary to sale of business). Accordingly, in the sale-of-business context, restrictive covenants binding sellers can extend for long periods (e.g., five years or more), and the buyer need not show an interest other than protection of its investment. The covenant may be enforced by action for breach of contract seeking injunctive relief and damages (not liquidated in the amount of earnout).

E. As a companion concept to the non-competes, buyers are typically seeking targets with superior current and historic track records that the buyers' distribution network can effectively market, and that have a pedigree that satisfies the institutions' reputational standards. The sellers and other employees may be required to be stripped of the right to utilize the performance track record of the target company and enter into long-term confidentiality and employee and investor non-solicitation arrangements, all of which limits their ability to compete through any venture outside of the target company.

VI. Minority Deals

A. The number of deals in which a buyer acquired a minority stake in an asset manager has remained relatively stable from 2011 to 2012, though we note a spike in the U.S.-based asset manager deals in the second half of 2012 as these managers raced to realize value before the scheduled increase on U.S. capital gains taxes took effect on Jan. 1, 2013.

B. In any minority deal, there is inherent tension between preserving the entrepreneurial culture of the firm, on the one hand, and the minority protections sought by the buyer, on the other hand. Moreover, many fund investors place a high value on managerial control and firm culture and, therefore, may need reassurance that the successful management and culture will be preserved. Nevertheless, it is very important that a manager understand up-front the degree of control, information and other rights that a buyer will expect to have. Consequently, these transactions often take on many of the traits of a joint venture.

C. Generally, buyers and sellers will settle on one of the following three structures, taking into consideration the degree of control that a seller is willing to provide to the buyer and the tax considerations relating to the sale and the ongoing business:

1. Net profit deals: in a net profit deal, the buyer shares in all or substantially all of the investment manager's expenses, which raises sensitivity to the management team's day-to-day decision-making. Since the operations have a direct impact on the buyer's revenue stream, buyers often require greater consent rights over various acts by the investment manager. Consent rights may relate to key employee hiring and termination, compensation, retention of third-party marketers, capital expenditures and other significant costs.

2. Pure gross revenue: at the opposite end of the spectrum — a pure gross revenue deal — expenses should not affect a buyer's return, which is tied to a percentage of revenue. That means the buyer has less reason to be concerned about spending decisions, and protective rights can be limited to extraordinary corporate actions, such as sales of the business and changes to the business plan, or actions that impact value.

3. Hybrids: in a modified gross deal, where only certain specified expenses, or expenses capped at a percentage of revenues, are netted out of the investment manager's revenues, there is a balance of protections, which may kick in only if an action is expected to result in the investment manager exceeding an expense cap.

D. And, of course, many of the restrictive covenant issues that we see in other asset manager transactions may be of issue in a minority deal. The sellers and sometimes other key personnel are typically required to enter into employment agreements, non-competition agreements and other restrictive covenants. The term of employment and the non-compete may be tied to the term of an earnout, if there is one, and range from two to five years or more. The consequences of terminating employment (for example, whether quitting constitutes a breach of the employment agreement, forfeiture of the employee's ownership interest, damages, etc.) is a key issue and is never taken lightly by buyers or sellers.

Schulte Roth & Zabel

Investing in Corporate Credit

Speakers

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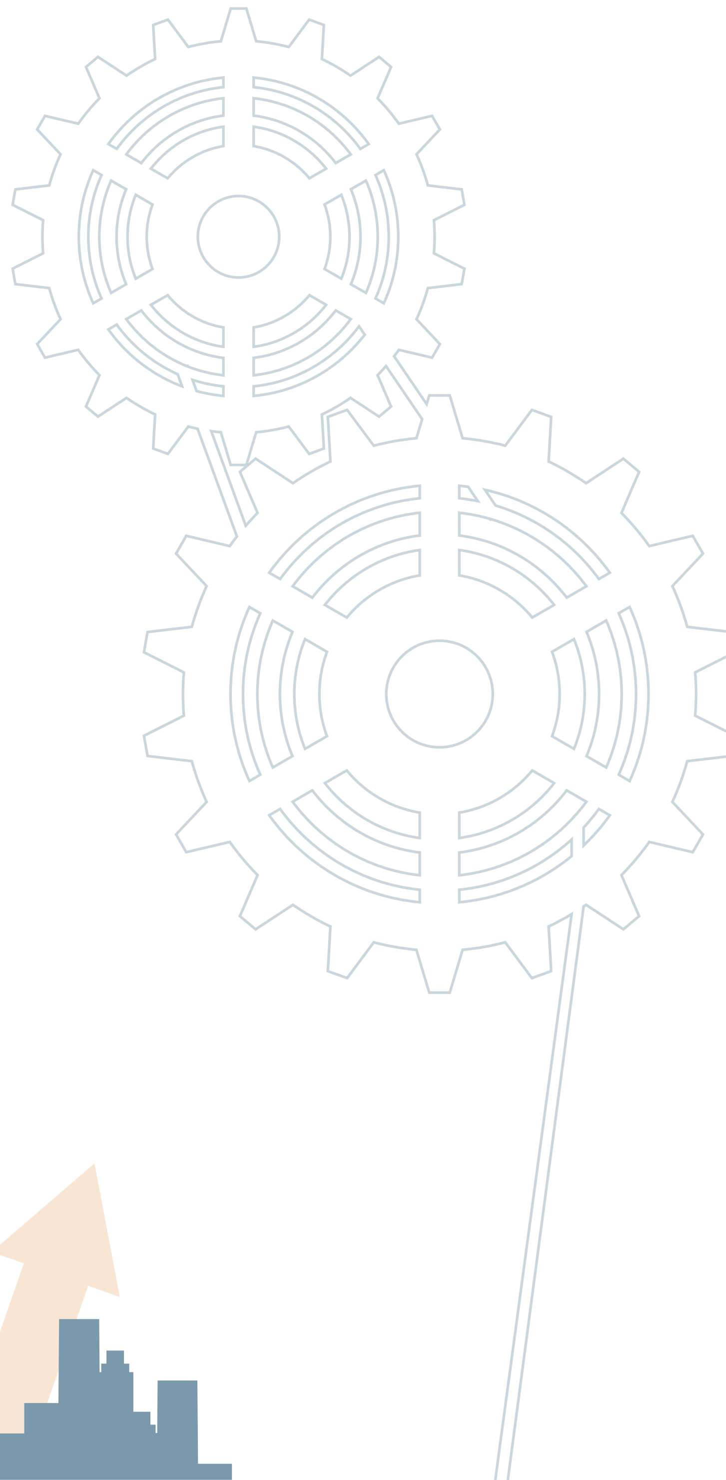
Omoz Osayimwese
Daniel Oshinsky
Craig Stein
Paul Watterson



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Dominique focuses her practice on U.S. federal income tax matters relating to investment funds, financial products and structured finance transactions.

In addition to her practice, Dominique provides thought leadership in her field by writing and speaking at industry conferences and events. Among other speaking engagements, she recently spoke at the Managed Funds Association's *Chief Financial Officer Forum* in respect of FATCA matters and also spoke on "Hedge Funds and Financial Transactions" at the ABA 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*.

Dominique is a member of the New York State Bar Association, the American Bar Association and the Integrated Bar of the Philippines. She is recognized by *The Legal 500 United States* and, in 2000, she received the prestigious AT&T Asia Pacific Leadership Award.

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Omoz focuses his practice on the representation of sponsors and investors in the formation and structuring of private equity funds, hedge funds and hybrid funds. He has extensive experience representing sponsors and investors on funds employing real estate, buyout, credit, distressed investment, 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 recent speaking engagements include "Private Equity Fund Managers: Developments in Marketing, Compliance and SEC Exams" at SRZ's *Investment Management Hot Topics* seminar and "Leverage for Investment Funds" at the firm's *Private Investment Funds Seminar*, as well as participating in a roundtable discussion at the AIFEA meeting regarding investment advisor registration for private equity firms and addressing "Emerging Managers: Raising a Hedge Fund in a Bear Market" at the HedgeWorld webinar.

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Dan 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 and leverage facilities, such as CLOs, warehouse lines, leverage finance vehicles, capital call facilities, management company loans and fund-of-fund loans. His 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: deal counsel for two hedge-fund sponsored CLOs, manager counsel for a CLO sponsored and managed by a specialty finance company, purchaser's counsel for acquisition financing used to acquire a franchisor in multiple states, counsel to the ad-hoc committee of a group of lenders in the out-of-court restructuring of debt issued by an enthanol plant opertator, counsel to a private equity fund in the negotiation and closing of a subscription line credit facility, counsel to the agent and lead lender for an asset based revolving credit facility to a merchandise importer, and counsel to a hedge fund for a warehouse credit facility secured by CLO bonds.

Dan presented on "Leverage for Investment Funds" at last year's *Annual Private Investment Funds Seminar*.

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Craig is co-head of Schulte Roth & Zabel's Structured Products & Derivatives Group. His practice focuses on swaps and other derivative products, including prime brokerage and customer trading agreements and related regulatory and compliance issues; structured products and other asset-backed transactions. He represents collateral managers, issuers, underwriters and portfolio purchasers in public and private structured financings, including collateralized loan obligations (CLOs).

Craig is a sought-after speaker for hedge fund industry conferences and has written widely on advanced financial products. He recently presented "Regulatory and Accounting Challenges and Hurdles" at IMN's *1st Annual CLO and Leveraged Loan Conference* and a "CFTC Update: What Fund Managers Need to Know" at SRZ's *Investment Management Hot Topics* seminar. His articles have appeared in publications such as *Credit* magazine, *Loan Market Week*, *Pratt's Journal of Bankruptcy Law* and the *Journal of Derivatives*. He recently co-authored "New Structural Features for Collateralised Loan Obligations," which appeared in *The International Comparative Legal Guide to: Securitisation 2012*.

Craig is a member of the American Bar Association, the New York State Bar Association, LSTA and various ISDA committees. 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 has also been recognized by *Chambers Global*, the *IFLR Guide to World's Leading Structured Finance and Securitisation Lawyers* and *The Legal 500 United States*.

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Paul is co-head of Schulte Roth & Zabel's 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, co-authoring articles for the *International Financial Law Review* and *Pratt's Journal of Bankruptcy Law*, among others. He recently co-authored "On the CLO Horizon — Regulations Expected to Impact CLOs" for *The International Comparative Legal Guide to: Securitisation 2012*.

Paul is listed in *Chambers Global*, *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*. Earlier is his legal career, 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.

Paul received his J.D., *magna cum laude*, from Harvard Law School, where he was an editor of the *Harvard Law Review*. He earned his A.B., *cum laude*, from Princeton University.

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Investing in Corporate Credit

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Investing in Corporate Credit

Notes:

Investing in Corporate Credit

I. Corporate Credit Investments and Strategies

A. Accessing the corporate credit market

1. There are many different ways to invest in corporate credits.

   (a) Types of debt: high-yield debt, secured debt, mezzanine debt, syndicated loans, private loans, ABL, cash flow.

   (b) Entry points: loan origination vs. secondary market.

   (c) Modes of acquisition: origination, assignment, participation, TRS, CDS.

2. Different types of credit have different seniority in capital structure. The lower in the capital structure, the higher the yield, and the greater the risk.

   (a) Debt priorities in the capital structure

      (i) Secured first lien

      (ii) Secured second lien

      (iii) Senior unsecured

      (iv) Mezzanine/subordinated debt

   (b) Revolving credit loans generally will be paid ahead of term loans in a liquidation. Asset-based loans are considered more secure than cash flow loans.

3. A fund's capital structure and available leverage will influence and, in many cases, dictate investment strategies.

   (a) In order to be a provider of revolving credit loans, a fund needs a source of capital it can regularly draw on. Funds that provide revolving credit use warehouse credit lines. Before the credit crisis, CLOs would issue revolving notes. This is no longer the case.

   (b) Funds that use CLOs or similar structured leverage facilities must comply with set investment criteria, concentration limits and rating requirements. This will limit the amount of second lien, unsecured or mezzanine-type debt that can be invested in.

   (c) Funds that invest in troubled or "distressed" credits must be able to hold investments long term, including during a bankruptcy or workout. Capital that cannot be readily redeemed is most suitable in this case.

4. From a U.S. tax perspective, one has to understand where the money is being raised by a U.S. borrower. Offshore investors have special considerations. For example, an offshore credit fund generally cannot "originate" loans to U.S. borrowers without running the risk of being engaged in a trade or business in the United States and being subject to U.S. net income taxation (e.g., 35 percent net income tax rate plus 30 percent branch profits tax plus state and local income taxes). Offshore funds have to invest in credits via the secondary market.

B. Corporate credit investments require significant diligence, asset management and back office resources.

1. Credit investing requires a fair amount of business and legal diligence.

(a) Information hurdles

(i) Borrower may not be a public company.

(ii) Relative seniority of your investment may depend on the terms of existing debt, the terms of other debt to be issued concurrently with your investment, or your ability to obtain liens on certain assets — all of this must be analyzed.

(b) Diligence

(i) Investors retain third parties to assist with diligence: valuations, quality-of-earnings reports, field audits, legal diligence.

(ii) Investors have face-to-face meetings with management.

(iii) Investors review the borrower's projections and construct their own models.

2. Credit terms may be significantly negotiated. Where multiple tiers of debt are being issued, in addition to negotiating with the borrower, the debt investors negotiate intercreditor arrangements as well.

3. Even purchases in the secondary market require back-office involvement to settle trades.

4. Credits require ongoing asset management.

(a) Monitoring for compliance, defaults.

(b) Credits may go through multiple amendments, and may go into bankruptcy or workout.

(c) Funds that are skilled at the bankruptcy process will use this to their advantage in a workout, to the detriment of those who are less savvy.

C. Investment strategies

1. Distressed investing and "loan to own" strategies

(a) Goal: extract the highest possible return or position the investor to become an equity holder.

(b) Requirements: committed, long-term capital; familiarity with bankruptcy process.

(c) Tax structuring for offshore money: loaning to own pass-through businesses or real estate, for example, requires "blocking" for offshore money not otherwise subject to U.S. net income taxation. Participation in the bankruptcy process may also require similar structuring, depending on the ultimate facts.

2. Investing in multiple tiers of the capital structure

(a) Goal: put investor in multiple positions so that it always has a portion of the "fulcrum" security.

3. White knights: rescuing "busted" syndications or companies in trouble

(a) Goal: extract best terms possible from company or syndicate under stress.

(b) Requirements: ability to move quickly and aggressively.

4. Private equity firms with debt investment arms may choose to invest in debt of a company they have already diligenced for possible acquisition.

II. CLOs from Warehouse to Close

A. Market update

1. CLO issuance pre-financial crisis

2. Comparison of 2010, 2011, 2012

3. Projected 2013

B. Warehousing

1. Why is it needed in 2013 and not in 2011 and early 2012?

2. Common structures

(a) Accumulate loans in CLO issuer

(b) Credit agreement or participation agreement

(c) Possibly a TRS

3. Risk allocation

(a) First loss provider

(i) CLO equity (all or a portion)

(ii) Investment manager related parties

(b) Placement agent provides financing

4. Typical terms

(a) Equity percentage (pre-/post-pricing)

(b) Financing cost — spread

(c) Duration

(d) Termination events

(e) Market value triggers

(f) Size of warehousing (percentage of deal size)

(g) Equity Returns

(i) Carry

(ii) Realized gains/losses

(iii) Unrealized gains/losses

C. CLO 2.0

1. Concentration limitations: portfolio composition

2. Eligibility criteria

3. Tranching

   (a) Moody's AAA/S&P down the capital structure/Fitch

4. Total size of deal

5. Refinancing/repricing

6. Reinvestment period

7. Non-call period

8. Tax issues

   (a) FATCA: contractual provisions remain fluid given that guidance and withholding requirements are phased in over several years.

   (b) U.S. trade or business: requirements for tax trading restrictions from warehouse through life of CLO; similar but not identical to guidelines followed by offshore credit funds.

9. Post-reinvestment period investing

10. Management fees

11. Key person cause events

12. Amend and extend

13. Typical AAA buyers; typical equity buyers

14. Collateral manager fee-sharing with equity

   (a) To attract equity

   (b) Affiliated equity buyers

   (c) Tax issues to offshore equity buyers seeking this additional return — best to structure as additional equity distributions in CLO documents.

15. Hot backup manager for new CLO managers (who should automatically be subject to the same tax trading restrictions as the original CLO manager).

16. Sub-advisers

D. Looming issues

1. Risk retention

   (a) Europe

   (b) U.S.

2. Hedging

   (a) CFTC issues

III. Investing in Legacy Structured Credit Assets

A. Opportunities in structured securities issued prior to 2009

   1. To gain by liquidating the underlying portfolio

   2. To improve performance by changing the servicer, the manager or trustee of the securities

   3. To improve performance by reinterpreting the issuance documents

   4. To improve performance by amending the issuance documents

   5. To gain from litigation against, *inter alia*, the originator, servicer, trustee or underwriter

   6. To repackage the legacy security into several tranches of new securities

B. Examples

   1. CDOs of RMBS

   2. RMBS

   3. CMBS

   4. Student loan ABS

C. Challenges

   1. If the goal is liquidation of the underlying portfolio:

      (a) Do the issuance documents permit liquidation (or a call of the securities, leading to a liquidation)?

      (b) If so, which party or class controls the decision to liquidate?

      (c) Are there conditions in the issuance document which must be satisfied before the portfolio is liquidated?

      (d) Will you be permitted to credit bid?

      (e) Will you be required to give an indemnity and pay liquidation expenses?

      (f) Will the underlying portfolio be acceptable, tax-wise, for all types of investors (i.e., U.S. taxable, U.S. tax-exempt, non-U.S.)?

   2. If the goal is to change the servicer, manager or trustee of the securities:

      (a) What party or class has the right to terminate the servicer/manager/trustee?

      (b) What party or class has the right to appoint a successor?

      (c) What indemnities or fee guarantees will be required?

      (d) What actions is the successor willing to take that will improve performance?

3. If the goal is to amend the issuance documents:

   (a) Whose consent is needed for the amendment?

   (b) Will the trustee require a legal opinion?

   (c) Will the amendments involving changes in rights and obligations of parties create a "deemed" taxable event for the existing security holders?

4. If the goal is not liquidation, but to improve performance based on reinterpretation of the documents:

   (a) How have the issuance documents been interpreted to date?

   (b) How do the issuance documents compare to the issuance documents for comparable transactions?

   (c) What party or class controls the interpretation of the documents?

   (d) Will an indemnity be required?

   (e) Is an interpleader proceeding likely to result?

5. If the goal is to profit from litigation:

   (a) What is the standard of care for the litigation target?

   (b) Is there an applicable indemnity given by the issuer to the target and, if so, will it reduce payments on your security?

   (c) Are there pending litigations against the target?

   (d) Has the statute of limitations expired?

   (e) Will the parent of the litigation target be responsible for its subsidiary's liabilities?

   (f) Do the issuance documents impose conditions that you must satisfy before bringing the litigation?

   (g) One needs to think through detailed investment steps/overall strategy to avoid any U.S. tax issues for offshore or U.S. tax-exempt money?

6. If the goal is to benefit from a repackaging:

   (a) What will be the costs of the repackaging (legal fees, placement agent fees, rating agency fees, etc.)?

   (b) In order to achieve your objectives, will it be necessary to sell at least one of the new classes of securities to a third party?

   (c) Will the repackaging transaction have adverse tax consequences for you as a seller?

   (d) Which of the new classes will retain the voting rights of the original, now repackaged, securities?

IV. Credit Funds

A. General

Credit funds are private investment funds that invest primarily in credit or other fixed-income investments and or make loans or acquire loans (or interests and participations in loans) in the secondary market.

B. Credit fund structures

1. Hedge fund structure

(a) A more traditional structure

(b) More common pre-2008 crisis

(c) Issues

(i) Hedge funds mark their assets to market and managers of hedge funds receive incentive realization on an annual basis based on net realized and unrealized gain.

(ii) Investors feel that there is more room for inaccuracy in the valuation of Level II or Level III assets and therefore, if managers are receiving incentive compensation based on the valuation of these investments they may be receiving more incentive compensation than they are due.

(iii) Investor demands in hedge-fund-style credit funds

(1) Clawback provisions

(2) Multi-year lock-ups on manager withdrawals of incentive compensation

(3) Incentive compensation to be determined at the end of a multi-year period (e.g., three years)

(d) Tax consequences of hedge fund structure

(i) Multi-year lock-up and the multi-year incentive compensation work for domestic funds structured as partnerships for U.S. tax purposes.

(ii) These provisions do not work for non-U.S. funds (e.g., Cayman funds) as they often run afoul of IRS rules on deferred compensation.

(iii) Incentive compensation structured as tax allocations do not create tax deferral issues; however, Internal Revenue Code Section 457A creates the risk of an additional 20 percent tax plus penalty interest when incentive compensation is structured as a fee paid by a typical offshore fund (for example) and the fee is not paid within 12 months from the end of the year of service, regardless of whether the failure of payment is due to the inability to value assets.

2. Private equity fund structure

(a) Manager/general partner receives carried interest only on a realized basis.

(b) Distribution waterfalls can be deal-by-deal, but credit funds often have cumulative return of capital waterfalls where the general partner receives carried interest only following a return to investors of all contributed capital to date and a preferred return.

(c) Some credit funds (e.g., certain mezzanine debt funds) have two waterfalls — one for interest income and a separate waterfall for disposition proceeds.

(i) Interest waterfall allows the GP to receive carried interest as a share of interest income.

(ii) Disposition proceeds waterfall looks like typical PE fund waterfall (i.e., return of capital, preferred return, catch-up and 80/20 split).

(d) Manager's carry typically is structured as a tax allocation and because of the manager entity's back-ended entitlement to distributions, a tax distribution provision is typically provided to benefit the manager and any clawback is done on an after-tax basis.

3. Hybrid fund structure

(a) Credit funds investing in credit instruments or loans trading on the secondary market are set up using hybrid structures.

(b) Incorporate terms and provisions common to both PE funds and hedge funds.

(i) Manager is paid on a realized basis on the more illiquid parts of the fund's portfolio (a PE fund attribute).

(ii) May have perpetual fundraising, withdrawal rights and investment by subsequent investors based on NAV (hedge fund attributes).

C. Tax structuring issues

Credit funds have some unique tax issues based on the type of strategy and the investor base of the particular fund.

1. Loan origination

(a) Many funds engage in loan origination. The primary issue here is that for non-U.S. investors, loan origination often results in an additional (and likely economically unfeasible) tax burden because income from loan origination is likely to be income effectively connected to the conduct of a U.S. trade or business ("ECI"). As noted above, the effective tax burden can exceed 60 percent with federal, state and local taxes combined.

2. Workouts

(a) Investments in distressed debt that require workouts or refinancing can also generate ECI.

3. Mortgages

(a) Investments in mortgages and other real estate-backed instruments also require special consideration: residential mortgages cannot typically be purchased outright by non-U.S. funds without being subject to withholding taxes (30 percent on gross interest income). Possible foreclosures also require a consideration of potential FIRPTA issues — typically, the possibility of owning direct real estate requires the use of a taxpaying corporate entity.

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Sponsors and Their Portfolio Companies in Distressed Situations

Speakers

William Gussman
Adam Harris
David Hillman
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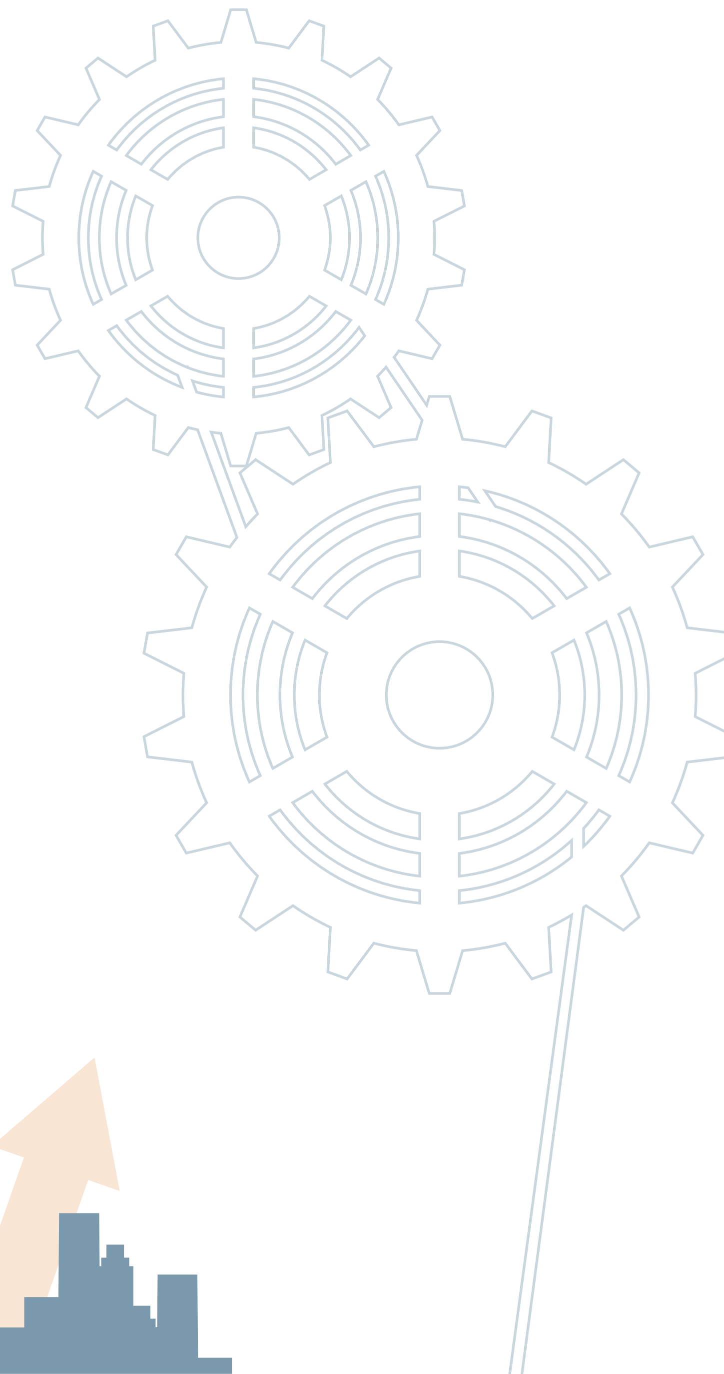

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Practices

Litigation

William H. Gussman, Jr.

Bill represents financial institutions and officers and directors in complex commercial litigation, including in securities fraud actions, fraudulent transfer actions, post-acquisition disputes and derivative actions. His clients have included leading prime brokers, hedge funds, private equity firms, investment banks, lenders and individuals. Bill has substantial trial experience, having tried cases in federal and state courts throughout the United States and in a variety of alternative dispute resolution venues, including AAA, FINRA and JAMS arbitrations. Bill frequently litigates in bankruptcy court, often representing noteholders in disputes over such things as enterprise valuation and asset ownership. He has also assisted clients in responding to SEC investigations and requests.

Bill's jury trial experience includes the successful defense of a leading prime broker in a $141.4 million fraudulent transfer action brought by the trustee of a defunct hedge fund. In that two-week federal trial, he helped to secure a unanimous verdict in favor of the prime broker, resulting in a complete win for the prime broker in a litigation in which the trustee initially claimed $3.6 billion in damages. Bill is currently representing a former officer and director of Merck & Co. in connection with proceedings relating to the painkiller Vioxx. That high-profile matter has included the defense of federal and state securities law claims, breach of duty claims, product liability claims and other matters.

Bill is a contributor to comprehensive treatises and workshops centered on his areas of expertise. He recently authored the "Obtaining Information from Corporate Insiders" chapter of the *Insider Trading Law and Compliance Answer Book* published by Practising Law Institute, co-authored "Regulation of Market Manipulation" for Matthew Bender & Company's *Federal Securities Exchange Act of 1934* and spoke at the SRZ/KPMG Conference, "My Portfolio Company Did What!? — Private Equity and the Perils of Alter Ego Liability."

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

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Practices

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Adam is chair of Schulte Roth & Zabel's Business Reorganization Group and a member of the firm's Executive Committee. He practices in the areas of corporate restructurings, workouts and creditors' rights litigation, with a particular focus on the representation of investment funds and financial institutions in distressed situations. Adam has represented a variety of clients in connection with distressed acquisitions by third-party investors or existing creditors through "credit bid" or similar strategies, as well as in court- supervised and out-of-court restructurings. In addition to representing creditors and acquirers in distressed situations, Adam has represented Chapter 11 debtors, as well as portfolio companies in out-of-court exchange offers, debt repurchases and other capital restructurings.

Adam's recent representations include advising a group of private equity funds, in their capacity as term loan holders, in connection with the "credit bid" acquisition of substantially all of the assets of Real Mex Restaurants, Inc. and its affiliates. Adam also advised on The Innkeepers USA Trust Chapter 11 reorganization and sale to Cerberus Capital Management LP and Chatham Lodging Trust, which was named the "Special Situation M&A Deal of the Year" (above $750 million) at the Turnaround Atlas Awards.

Adam writes and presents on topics related to his area of expertise. He recently co-authored "Out-of-Court Restructurings, the Bankruptcy Context, and Creditors' Committees" for the *Insider Trading Law and Compliance Answer Book*, which is published by the Practising Law Institute.

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Practices

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David practices in the areas of corporate restructuring and creditors' rights litigation, with an emphasis on representing secured and unsecured creditors, bondholder groups and other parties in Chapter 11 cases in industries including retail, manufacturing, broadcasting, automotive, telecom and energy. He litigates issues involving plan confirmation, valuation, solvency, financing and cash collateral disputes, contested Section 363 sales, fraudulent transfers, preferences, breach of fiduciary duty and similar disputes.

David's recent representations include a group of second-lien noteholders in the Chapter 11 case of a restaurant chain in their successful acquisition of the company's assets in a Section 363 sale, and a group of unsecured bondholders in the successful restructuring of an international technology company. He is currently representing first-lien noteholders and DIP lenders in the Chapter 11 case of Digital Domain Media Group.

David was named a "leading individual" and recognized by *Chambers USA* in bankruptcy/restructuring and is a member of the American Bankruptcy Institute. A frequent author on subjects in his area of expertise, David's articles on fraudulent transfer, reorganization finance and other topics of interest to the creditor community have appeared in *Pratt's Journal of Bankruptcy Law*, *Law360* and *Turnarounds & Workouts*. Other articles have appeared in *The Bankruptcy Strategist*, *Troubled Company Reporter* and *Equipment Leasing Newsletter*. David is also a frequent speaker at industry events and recently presented "Subjecting Business Projections to Scrutiny in Valuation Disputes" at the ABI's *14th Annual New York City Bankruptcy Conference*.

David received his J.D., *cum laude*, from Albany Law School, where he was associate editor of the law review, and his B.A., *cum laude*, from New York State University at Oneonta.

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Ron is 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, non-solicit, and breach of confidentiality and breach of loyalty issues. Ron defends employee benefit plans, fiduciaries and employers in class actions and in cases brought by individual plaintiffs. He represents employee benefit plans before the U.S. Department of Labor, the Pension Benefit Guaranty Corporation and the Internal Revenue Service in connection with novel issues of law concerning plan mergers, terminations, spin-offs, fiduciary duties and prohibited transactions, and various aspects of withdrawal liability and mass withdrawal liability. 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. In 2012, he presented "Stock Drop Litigation: Are We Done Yet?" at a National CLE Conference event. He also has authored several recent publications, including "The Benefit of Whose Bargain? Courts Grapple with Administrative Expense Priority For Postpetition Withdrawal Liability Claims" for the *Norton Journal of Bankruptcy Law and Practice*.

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. He is also a former New York University adjunct professor.

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

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Practices

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Phyllis focuses her practice on the structuring, formation and operation of private equity funds, including buyout funds, venture capital funds, mezzanine funds, distressed funds, real estate funds and small business investment companies. Phyllis represents both fund sponsors and investors in her practice. In addition to assisting fund sponsors with their internal management arrangements and the creation of internal investment vehicles, she has extensive experience with institutional investors and regularly advises on the acquisition and disposition of partnership interests and market terms of investment funds. Phyllis also represents private equity funds in connection with their investments in, and disposition of, portfolio companies.

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 discussed "Fine Tuning the Nuances of Performance Reporting Standards in Today's Landscape" at FRA's *2nd Annual Private Equity Operations and Compliance Forum* and "Fund Formation: New Tax Issues and Developments" at FRA's *3rd Annual Private Investment Funds Tax Master Class*. She is co-author of *Private Equity Funds: Formation and Operation* (Practising Law Institute), which is considered the leading treatise on the subject.

Phyllis is recognized as a leading practitioner in her field by numerous independent publications, including *The Best Lawyers in America*, *The International Who's Who of Private Funds Lawyers*, the *IFLR Guide to the World's Leading Investment Funds Lawyers*, the *IFLR Guide to the World's Leading Private Equity Lawyers* and the *IFLR Guide to the World's Leading Women in Business Law* (Investment Funds).

Phyllis received her J.D. from Columbia University School of Law and her A.B. from Smith College.


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Sponsors and Their Portfolio Companies in Distressed Situations

Notes:

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I. Responding to the Distressed Portfolio Company

A. Introduction

1. Funds will inevitably end up holding a distressed investment, whether or not they are formed for the purpose of making distressed investments.

2. Funds generally have two main resources to be utilized in support of their distressed portfolio companies — their capital and their investment professionals.

3. While no two distressed situations are alike, funds are in a better position to serve their portfolio companies, and in turn their investors, by having greater flexibility to deploy capital and to make their team available to help them onsite.

4. The economic downturn has magnified the need to anticipate distressed situations.

B. Addressing the need for additional capital of a portfolio company

1. Once it is determined how much additional capital a portfolio company needs, the manager should evaluate whether the funds that it manages are permitted to invest additional amounts.

   (a) A private equity fund's limited partnership agreement (or limited partnership agreement of a side pocket/hybrid fund) generally caps the amount that can be invested in a single company and the affiliates of that company. Alternatively, a fund may follow internal policies (disclosed in the offering memorandum) the restrict amounts invested in a single company.

   (b) Other caps may restrict further investments in a company, such as geographical limits and industry concentration.

   (c) Additional investments in a company may also be restricted once a fund's investment period expires, due to the total amount that investors allow for follow-on investments. Typically, for private equity funds there is a cap of 20 percent to 30 percent of committed capital permitted for follow-on investments in all portfolio companies after the investment period expires (as opposed to a cap on the amount permitted to be invested in a single company at any time).

   (d) The type of investment to be made could also be restricted. For instance, a manager may determine that a debt investment is best suited for the fund's follow-on investment in a company, but the fund's partnership documents may not permit debt investments.

2. Managers should consider whether their funds should invest smaller amounts initially in a portfolio company thereby allowing for greater capacity to make follow-on investments.

   (a) Historically, venture capital funds have anticipated needing roughly 100 percent follow-on capacity, while later state equity funds have reserved smaller amounts for follow-on investing. This approach is reversing.

   (b) If funds initially invest smaller amounts in a company, there is likely to be a greater need to seek coinvestors to support the size of the transaction.

3. If the fund is making the investment, the manager will then determine how to structure the fund's investment.

(a) The manager must determine whether the fund will make an equity investment or debt investment (or both).

(b) Equity investments present greater risks for funds, but can be structured with rights that are senior to other equity securities of the issuer.

(c) Debt securities present less risk, but may be subordinated to other creditors rights or otherwise subject to later challenge.

(d) If the investment is expected to be short-term in nature, the manager should consider whether the proceeds from the investment will be subject to reinvestment.

(e) Depending on the structure, the new investment could result in one investor or group of investors who participate in the new investment receiving better rights than those investors in the initial investment.

4. If the fund is not permitted to invest additional amounts in a distressed company, the fund's manager will likely assist the company in finding the capital.

(a) Existing investors in the issuer are often a likely source of capital, as they will want to protect their own investment.

(b) Limited partners of a fund that does not have the capacity to invest may similarly want to protect the value of their own fund's assets. If limited partners are willing to invest more capital, the manager will consider whether the investment is made within or outside the fund.

(c) New investors seeking distressed opportunities are potential sources.

(d) The company might be able to obtain additional loans; however, the fund might need to advance funds to cover expenses of the lender in advance of the new loan. The fund's new capital could be repaid out of the new loan.

(e) As a last resort, the manager and its employees may wish or be willing to make an investment in the company. This presents difficult conflict issues, particularly where the rights associated with the new investment are senior to those associated with the fund's existing investment.

5. It will often be difficult to avoid conflict situations in making follow-on investments in distressed situations.

(a) If an affiliate (including affiliated funds) makes a follow-on investment where the other affiliated fund is not able to participate, the investing entity will likely need to exercise rights that could be adverse to other affiliated funds.

(b) Disclosure of the possibility of investing at different levels of the capital structure by affiliates should be made in a fund's offering documents. Further, the fund's partnership documents should permit affiliates to invest in a portfolio company if the fund is not permitted to do so at the time, although most fund documents will require the limited partner conflicts committee to approve such investment.

(c) A valuation of the new investment by an independent party will help to ensure that the new investment is not unfairly diluting the original investment.

(d) To the maximum extent possible, affiliated investors should divest their positions in the same company at the same time.

(e) A fund manager with representatives on the board of directors and committees representing debt holders is likely to face conflicts.

(f) A transaction fee charged by a fund's manager on the fund's investment in a distressed company could adversely affect the company while benefiting the manager. Management fee offsets triggered by transaction fees could be viewed to mitigate this conflict.

(g) Limited partner conflict committees are important features of private equity funds. Conflicts can be presented and possibly cleared with this committee. More recently, committee members are less willing to approve or disapprove conflict situations. Fund documents should absolve committee members for liability, other than bad faith, and provide indemnification protection. Conflicts committees may receive the right to retain their own counsel at the expense of the fund.

C. Addressing the need for better management of a portfolio company

1. Board representation for equity investors allows a fund to give direction to its portfolio companies' operations and gives the fund access to information.

(a) Board representation may give the fund actual control of a portfolio company.

2. Funds are providing their own investment professionals to support portfolio companies.

(a) Generally, these individuals work on a temporary basis for the portfolio company.

(b) The time commitment of fund professionals to the fund required by fund documents should allow individuals to provide on-site assistance to portfolio companies directly.

3. Income paid to fund professionals could trigger offsets to the fund's management fees.

(a) Fund documents should carve out this income from offsets.

D. Conclusion

1. Greater flexibility in fund investments can be achieved through the following:

(a) Establishment of a limited partner conflict committee: this committee is an important feature of a fund. Both conflicts and investment restrictions can be addressed with the committee.

(b) Providing more flexible reinvestment rights: a fund will have greater capacity to make follow-on investments by utilizing the proceeds from a successful investment to support a distressed investment.

(c) Providing coinvestments disclosure fund documents; coinvestment opportunities also are likely to attract investors to funds.

II. Alter Ego/Bankruptcy Issues

A. Concept of limited liability

1. *"Limited liability is the rule, not the exception; and on that assumption large undertakings are rested, vast enterprises are launched, and huge sums of capital attracted."* Justice Douglas

2. *"A corporation and its shareholders are generally to be treated as separate entities. Only under exceptional circumstances…can this difference be disregarded." Burnet v. Clark*, 287 U.S. 410, 415 (1932).

3. These concepts and principles still hold true today, but the presumption of separateness — between a parent company and its affiliate, between a private equity firm and its portfolio company, and between a corporation and its shareholders — is not absolute.

   (a) The law books are filled with cases in which a court found it necessary to pierce the corporate veil and hold a parent liable for the contractual breaches or torts of its affiliate.

   (b) Any plaintiffs' lawyer with $200 and a typewriter can file a complaint naming a subsidiary's parent company as a co-defendant.

      (i) Hundreds of cases, if not more, are filed each year, in which — through the simple twist of some boilerplate language borrowed from a form book — a plaintiff names the deep-pocketed parent.

         (1) "Alter ego"

         (2) "Dominated and controlled"

         (3) "Mere instrumentality"

         (4) "Puppet-master"

   (c) And if a plaintiff can get past the motion to dismiss stage — if the complaint can survive long enough to entitle the plaintiff to engage in a discovery fishing expedition — many times, enough can be found to convince a judge or jury that the parent should be held liable for the acts of its portfolio company.

B. Alter ego liability

1. The standard

   (a) The test employed by courts differs from jurisdiction to jurisdiction.

      (i) But, as a general matter, equity holders are generally not liable for the acts of the companies in which they invest.

         (1) *"It is a general principle of corporate law deeply ingrained in our economic and legal systems that a parent corporation (so-called because of control through ownership of another corporation's stock) is not liable for the acts of its subsidiaries." United States v. Bestfoods*, 524 U.S. 41, 61 (1998).

      (ii) To pierce the proverbial corporate veil, a plaintiff must show some combination of the following elements, usually in the conjunctive and not disjunctive.

         (1) Complete domination and control

            a. The level of domination and control over the portfolio company's finances, policy and business practices must be complete such that the subsidiary "has no separate mind, will, or existence of its own."

               i. Thus, the PE firm that monitors its portfolio company's performance, supervises its financial decisions and sets general policy goals should not expose itself to alter-ego liability in the absence of other factors. Indeed, PE firms owe fiduciary duties to their investors and therefore should not be chilled in their prudent management and oversight of their portfolio companies.

ii. *“Leading interventionists provide substantial management talent to their portfolio companies during the initial phases of each investment and subsequently support the evaluation of important strategic choices.”* Klier, Welge, Harrigan, “The Changing Face of Private Equity: How Modern Private Equity Firms Manage Investment Portfolios,” *Journal of Private Equity*, Fall 2009, at 10.

iii. *“Private equity professionals take on a more active role on the boards of companies they own…Board meetings are used as a platform for discussion…rather than being just about passing management proposals.”* Klier, Welge, Harrigan, “The Changing Face of Private Equity: How Modern Private Equity Firms Manage Investment Portfolios,” *Journal of Private Equity,* Fall 2009, at 9.

iv. Examples of indicia of complete domination and control:

- All corporate decisions for the affiliate are made by the parent.
- All expenditures need to be approved by the parent.
- The board of the affiliate is dominated by the parent.
- The parent micro-manages almost every aspect of the affiliate’s business.

(2) Fraud, inequity or improper use

a. Domination and control of a portfolio company — in and of itself — ordinarily should not be enough to sustain an action for piercing the corporate veil.

i. In fact, if the plaintiff has only alleged domination and control, the complaint has failed to state a cause of action and should be dismissed at the earliest stages of the case.

ii. If domination and control, alone, was enough, there would be no such thing as limited liability for single shareholder companies.

b. Courts will look to see whether the subsidiary is a “sham” or a “dummy” company.

i. Seventh Circuit described sham companies as “mere figments, little more than corporate names held up like picket signs by an individual who is individually responsible for the putative corporation’s assets.”

ii. Courts look to whether the parent is making use of the affiliate’s funds or assets. Put another way, is the affiliate the personal piggy bank of the parent company?

c. Is the parent using the affiliate’s assets as its own?

d. Is the parent paying its liabilities through the affiliate?

e. Is the parent running its own expenses through the affiliate?

f. Is the affiliate respecting corporate formalities?

g. Is the affiliate properly capitalized?

h. Is their transparency when third parties do business with the affiliate?

(3) Causation

a. Finally, even assuming that a plaintiff was able to plead — much less prove — a parent's complete domination and control over a subsidiary, which was abused in some form or fashion, for the proverbial corporate veil to be pierced, the plaintiff still needs to prove causation — that is, that the improperly used domination and control was the proximate cause for the alleged damages suffered by the plaintiff.

(iii) Thus, for a piercing/alter-ego claim to be pled and proven, a plaintiff must show three things:

(1) Total domination and control;

(2) Fraud, inequity or improper use of that control; and

(3) Causation.

(iv) The test varies from jurisdiction to jurisdiction, but essentially it comes down to those three elements, each of which may have sub-elements that are probative.

2. Factors the courts look to

(a) Courts look at many factors.

(b) None is dispositive; aggregate of factors.

(i) Majority ownership of subsidiary

(1) It is almost uniformly accepted that majority ownership, alone, will not amount to total domination and control for imposing alter ego liability in the absence of other factors.

a. Indeed, PE firms are often designed to control a portfolio company through ownership of all or substantially all of a company's equity in order to maximize returns for their investors.

(ii) Common officers, directors and employees

(1) Like majority ownership, PE firms often appoint principals of the firm to serve as directors and officers of their portfolio companies, and alone, is not sufficient to impose alter ego liability.

(iii) Parent company providing financing to subsidiary

(1) Courts have acknowledged this is permissible as long as the companies continue to observe corporate formalities.

a. *"[A]s long as it maintains corporate formalities, a parent may provide financing to its subsidiary or approve expenditures or sales by the subsidiary."*

(iv) Inadequate capitalization

(1) Companies that are inadequately capitalized are often viewed suspiciously by courts, and undercapitalization is often an important point of analysis in piercing cases.

a. But, PE firms are not required to throw "good money after bad" by recapitalizing a failing portfolio company.

i. The proper analysis should be whether the portfolio company was properly capitalized at the time of its inception — not later on.

(2) In situations where the portfolio company has fallen onto hard times, heightened precautions are needed to ensure that the PE firm's efforts to save the portfolio company do not have the unintended consequence of making the PE firm liable for the acts of its portfolio company under an alter-ego theory.

(v) Paying salaries/payroll issues/"a division"

(1) Adhere to general corporate formalities

a. Pay salaries from the appropriate corporate entity

b. Consultant agreements

c. "A division of"

i. *Pace Indus v. Dannex, Mfg Co*., 394 Fed.Appx. 188 (6^{th} Cir. 2010) (court pierces when, among other things, one company's president received his salary from other company).

ii. *Amoco*, 838 S.2d 821 (piercing in a case where the parent referred to its subsidiary as its oil and gas division).

iii. Good internal controls and procedures are needed.

- More difficult when the acquired portfolio is a family-run business or otherwise operated in a regime that didn't mandate tight internal controls.

d. Commingling assets

i. Courts often consider whether the parent uses the property or assets of the subsidiary as its own.

- Surest way to alter ego liability.

e. Dealing with portfolio company informally

i. Do the parent and portfolio company operate at arm's length?

- E.g., does parent make loans to the portfolio company without corporate resolutions authorizing the loans or demands of collateral or interest.

f. Other accounting/financial issues

i. Courts have paid attention to whether the tax returns of parents and subsidiaries evidence two separate companies and whether there are irregularities on financial statements that demonstrate that one company has control over the other.

- *Pace Indus.*, looking at tax returns and finding that the tax returns evidenced the parent's control, including that the subsidiary's costs of goods were zero percent of its gross receipts.

- *Carte Blanche*, finding that the subsidiary's revenues were treated as part of the parent's revenues and combined into the parent's financial reports.

3. Invasive discovery (HG/BG)

(a) Plaintiffs will seek broad, expansive discovery.

(i) Information relating to the deal in which the PE firm acquired the company (anything that could evidence the parent's desire/intent to control the portfolio company)

(1) Purchase agreement

(2) Deal documents

(3) Due diligence

(4) Negotiations

(5) Investment committee memos

(6) Valuations

(7) Business plans

(ii) Corporate formalities

(1) Board minutes

(2) Board resolutions

(3) Notes of board meetings

(4) Board packages

(5) Agenda

(6) Notices

(iii) Management agreements/consultant agreements

(1) PE firms often provide consultants or other executive-level personnel with relevant expertise into a newly-acquired portfolio company.

a. Nothing wrong with this.

i. But, is the relationship formalized?

- The absence of a management or consultant agreement is not a good fact.

ii. Are the consultants actually calling the shots or are they reporting to company management?

(iv) Management of the new portfolio company

(1) Who are the new managers?

(2) Who's calling the shots?

(3) What approvals are needed by the portfolio company?

a. How granular is the PE firm's oversight?

(4) Does "new management" have a long history with the PE firm?

(v) Communications between:

(1) The PE firm and the portfolio company.

a. Particularly troubling, potentially, are emails, notes, meetings, etc., in which the PE firm is dictating action items to the portfolio company's senior managers.

(2) The PE firm and third parties.

(vi) Financial records

(1) Do they evidence control?

a. Financial approval process

i. Receivables and accounts payable

(2) Detailed information relating to which individuals at the PE firm had access to the financials and the extent to which they were involved in preparing, or had control over, the company's financial statements and books and records.

(3) The structure of the company's and PE firm's bank accounts and banking relationships.

(vii) Observance of corporate formalities

(1) Corporate structure charts

(2) Board meetings

(3) Attendees

(4) Minutes

(viii) Information relating to the PE firm's other portfolio companies

(1) Is there a pattern of control reflected in those relationships?

(2) All manner of information (as above) will be sought.

4. How these issues arise in bankruptcy

(a) *In re BH S & B Holdings LLC*, No. 08-14604(MG), 420 B.R. 112 (Bankr. S.D.N.Y. 2009).

(i) The PE firm Bay Harbour purchased Steve & Barry's assets in a Chapter 11, section 363 sale. The purchasing entity Holdings was capitalized with a first lien loan facility from a third-party lender and capital contributions from Bay Harbour, York Capital and Hilco.

(ii) In November 2008, Bay Harbour and York knew that Holdings needed additional capital to survive, but refused to provide it. Holdings filed for bankruptcy later that month.

(iii) In April 2009, the unsecured creditors' committee brought an adversary proceeding seeking to, among other things, pierce the corporate veil against Bay Harbour and York and hold them liable for Holdings' debts and obligations.

(iv) The Committee alleged that Holdings was undercapitalized, had failed to observe corporate formalities, and was "merely a façade for the operations of the dominant parent."

(v) The Committee specifically asserted that: (a) the company failed to hold board meetings; (b) the company had no CEO until late 2008, and even then the CEO had no real authority; (c) Bay Harbour exercised strict control over the funds used by management; and (d) the company was inadequately capitalized.

(vi) The Court held that those allegations were insufficient under Delaware law to pierce the corporate veil, and granted the defendants' motion to dismiss.

(vii) *"These cases all show that allegations such as the Committee's here are insufficient to survive a motion to dismiss, because even if true they would not rise to the level of injustice or fraud that would justify disregarding the corporate form." Id.* at 142.

(b) *In re AlphaStar Ins. Group Ltd*., 383 B.R. 231 (Bankr. S.D.N.Y. 2008).

(i) AlphaStar was a risk management services and products company owned by affiliates of Goldman Sachs. Goldman took the company public in 1997, and after the IPO, remained a large shareholder who provided investment banking services to the company. Goldman executives also sat on the board of directors.

(ii) The company eventually filed for Chapter 7 liquidation. The Chapter 7 trustee commenced an adversary proceeding against former directors and officers, Arthur Andersen and several Goldman entities seeking to, among other things, pierce AlphaStar's corporate veil to hold the Goldman entities liable for its debts.

(iii) The trustee alleged that the Goldman entities — which were comprised of Goldman Sachs and Goldman investment funds — exercised an "inordinate amount of control over AlphaStar creating an extreme unity of interest and ownership, such that the Goldman Sachs Entities and AlphaStar no longer had separate personalities." *Id.* at 279.

(iv) The Court held that, under Bermuda law, the Chapter 7 trustee's veil piercing claim was insufficient given that it merely alleged that the Goldman entities had appointed their own employees on AlphaStar's board of directors and the Goldman entities owned a large percentage of AlphaStar's stock.

(1) *"The Amended Complaint does not allege facts showing that AlphaStar was a 'mere façade,' used by the Goldman Sachs Entities to perpetrate a fraud. AlphaStar was a separately incorporated, public company. ... The Amended Complaint does not identify the facts that support the Trustee's information and belief, and this appears to be another conclusory allegation of control based on share ownership and the nomination of its employees to positions on the Board. The conclusory allegation is insufficient under American pleading rules to state a claim to pierce the corporate veil based on fraud." Id.* at 279.

(c) *Extended Stay*, Adv. Proc. No. 11-02254 (Bankr. S.D.N.Y.) (currently pending).

(i) The trustee for the Extended Stay litigation trust sued Blackstone for claims relating to the 2007 leveraged buyout of Extended Stay. The trustee alleged that the LBO devastated the chain and drove it into bankruptcy, and that the Blackstone-affiliated sellers worked in concert with a buyer that assumed little risk of loss.

(ii) The trustee asserted alter-ego claims against the Blackstone entities arguing that they should be held liable for the debts of the debtors because they were alter egos of the debtors prior to and in connection with the LBO. The trustee alleged that Blackstone dominated and controlled the debtors and used that control to cause the debtors to incur indebtedness for Blackstone's sole benefit.

(iii) As of Dec. 19, 2012, the defendants' motion to dismiss has not yet been decided.

(d) Standing to assert veil-piercing claim in bankruptcy

(i) One unique issue that arises in the bankruptcy context is who has standing to state a claim for piercing the corporate veil: is it the bankrupt corporation, the creditors committee, the Chapter 7 or 11 trustee, individual creditors.

(ii) The issue is whether the claims are "property of the estate," and turns on whether the claim is a general one belonging to all of the debtor's creditors, or a direct claim belonging to individual creditors.

(1) "In a non-bankruptcy context, a creditor can invoke piercing to satisfy its claim from the assets of another corporation or person, but once bankruptcy ensues, the trustee alone has standing to prosecute the claim. Consequently, the creditors are prevented from pursuing the piercing claim unless and until it has been abandoned by the estate or the creditor obtains relief from the automatic stay." *In re Keene Corp.,* 164 B.R. 844, 851 (Bankr. S.D.N.Y. 1994).

C. Practice points

1. Observe corporate formalities.

(a) Board meetings

(b) Minutes

(c) Resolutions

2. Arm's length relationship.

3. Make sure dual officers and directors are wearing the right hats at the right time.

(a) OK to share officers and directors.

(i) However, be mindful that when they act on behalf of the portfolio company, they must act in the portfolio's best interests and avoid conflicts of interest.

4. Maintain separate operations.

(a) Separate officers

(b) Telephone numbers/fax numbers

(c) Email addresses

(d) Letterhead

(e) Facilities

(f) Employees

(g) Avoid referring to the portfolio company as a division or department.

(h) Dual employees should make sure they use the right business cards, stationary, email domains and should allocate time appropriately.

(i) Payroll issues

(i) Keep your hands out of your portfolio company's pockets.

(i) Not a piggy bank.

(ii) Loans should be documented and the portfolio company should not be so dependent on these loans that it cannot stay in business without them.

(1) If the portfolio company is distressed, and the PE firm is the lender of last resort given that no other reputable lender is willing to take the risk, there is a fine line between engaging in permissible financing and allowing the portfolio company to become an empty shell.

(2) Loans that are not repaid or do not bear interest can be problematic.

(3) PE firms are not required to recapitalize failing portfolio companies but the imposition of new obligations on a failing portfolio company without an infusion of new equity capital may evidence undercapitalization.

III. Employment Issues

A. Control group liability under ERISA

1. Potential liability

(a) The actual employer of employees (i.e., the portfolio company), as well as all entities that are under "common control" with that employer are treated as a single employer under the Employee Retirement and Income Security Act ("ERISA"). All these entities are jointly and severally liable under ERISA for various employee benefit qualified plan liabilities, including:

(i) Withdrawal liability to multi-employer pension plans;

(ii) Liabilities arising from the termination of single-employer pension plans; and

(iii) COBRA health plan continuation coverage, even if the actual employer goes out of business and ceases to maintain its own health plan.

(b) ERISA has an objective test for determining if an entity is in a control group with an employer. In addition, under the common law developed by the courts over the years, an entity other than the actual employer can be found liable for the foregoing liabilities if the court finds that through its ownership and actions it is an alter ego or joint employer with the actual employer.

2. Objective test

(a) ERISA and the Pension Benefit Guaranty Corporation's ("PBGC") regulations incorporate Internal Revenue Code ("Code") Section 414(c) and Internal Revenue Service regulations to determine common control. The relevant regulations are very briefly summarized below.

(i) Parent-subsidiary group (Reg. § 1.414(c)-2(b))

(1) Trades or businesses connected through ownership of a "controlling interest" with a common parent organization.

(2) With respect to corporations, a "controlling interest" means ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock.

(3) With respect to partnerships, a "controlling interest" means ownership of at least 80 percent of the profits interest or capital interest of such partnership.

(ii) Brother-sister group (Reg. § 1.414(c)-2(c))

(1) Two or more entities if the same five or fewer individuals, estates or trusts have:

a. A "controlling interest" (80 percent or more vote or value) in each organization; and

b. "Effective control" (more than 50 percent) of each organization, considering a person's ownership only to the extent it is identical for each organization. To determine whether there is effective control, with respect to corporations, it is ownership of more than 50 percent of stock with voting power or value; with respect to partnerships it is more than 50 percent of profits interests or capital interests.

(iii) Combined group

(1) A group of three or more organizations each a member of a brother-sister or a parent-subsidiary group, if at least one of the organizations is both the common parent of a parent-subsidiary group and a member of a brother-sister group.

(b) The regulations also have detailed provisions on attributing ownership by some parties to other parties to determine whether a sufficient amount of ownership or voting power exists to trigger control group liability, including attributing ownership by management of portfolio companies to another entity, particularly where there are restrictions on management's rights with respect to its disposition of ownership interests. *See* the attached Appendix for a brief summary of some of these rules.

(i) "Partnership" or "joint venture" under Code Section 7701

(1) A novel twist on the objective test is a legal theory recently asserted by some multi-employer pension funds in the federal court cases discussed below. Using this Code section, the pension funds were seeking to aggregate the ownership percentages by different investment funds (containing different investors, but with the same general partner and the same investment adviser) for purposes of the common control tests. These pension funds argued that, pursuant to Section 7701 of the Code, all such investment funds should be treated as one large partnership or joint venture for this purpose. Under Section 7701(a)(2), a partnership is

a "syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not … a trust or estate or a corporation." I.R.C. § 7701(a)(2). In *Luna v. Commissioner,* 42 T.C. 1067, 1077-1078 (1964) (internal citations omitted), the Tax Court set forth the following factors controlling whether a partnership exists.

a. *"The following factors, none of which is conclusive, bear on the issue: The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed Federal partnership returns or otherwise represented … to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise."*

(2) On the other side of this argument, there is a long line of tax case law concluding that ostensibly separate entities will be respected as such and not treated as constructively combined into one venture, absent special circumstances. *See*, e.g., *Moline Properties v. Commissioner*, 319 U.S. 436, 439 (1943) (although the corporate form can be disregarded if a sham, generally separate taxable entities are treated separately). The Michigan court referenced below had found that the Section 7701 factors were issues of fact that needed to be resolved at trial. The Massachusetts court, however, (discussed below) rejected the pension fund's arguments under Section 7701, finding that there was "no basis to extend the tax law's understanding of corporate forms into the realm of imputed liability."

3. Private equity funds and developments with application of the objective test

(a) Fundamental to the question of whether ownership by investment funds can even be the basis for control group liability — whether under the standard objective test or any attempt to aggregate different ownership by different investment funds — is whether investment funds are even "trades or businesses," rather than simply investment pools of money, such that they fall within the ERISA control group regulations.

(i) PBGC 2007 decision

In September 2007, the PBGC took a newly aggressive approach and found for the first time that a private equity fund was a "trade or business" and was the parent of its portfolio company. The PBGC rejected the argument that the private equity fund was simply a passive investment vehicle. Based on the delegation of full control over the business and affairs to the general partner, an agent of the fund, who received 20 percent of all net profits, the PBGC found that the fund was engaged in an activity with the "primary purpose of income or profit," and that the general partner managed the fund's investment activities with "continuity and regularity," which satisfied the Supreme Court's two-prong test for a trade or business. In that case there was only one investment fund which had a 96 percent controlling interest in the portfolio company. We have spoken informally with PBGC officials and the PBGC officials indicated that while they still support the 2007 opinion, they have not used it since 2007.

(ii) *Sheet Metal Workers Pension Funds v. Palladium Funds* Michigan District Court Decision 2010

The court accepted arguments made by multi-employer pension funds that the PBGC opinion should be followed because the private equity fund was actively involved in managing its portfolio investment. The court found the PBGC's reasoning persuasive and held it presented an "investment plus" standard in which a private equity fund may be considered a trade or business depending on how active it is in managing its investments. The case was settled and, therefore, the court did not further determine if this standard was met.

(iii) *Teamsters Pension Fund v. Sun Capital Funds* Massachusetts District Court Decision 2012

This court found the PBGC opinion unpersuasive and that it conflicted with Supreme Court precedent. The court also held that the funds were not trades or businesses and, therefore, not liable. In addition, the court opined that structuring the transaction so that three separate funds, with the same general partner, owned the portfolio company was not a transaction to avoid or evade ERISA. This decision is on appeal.

4. Common law theories

(a) In addition to the objective test above, common law tests for piercing the corporate veil such as "alter ego," "single employer" and "joint employers" have developed to determine the appropriate entities upon which to impose liability if the entities are intertwined sufficiently. To determine if entities are a single employer, courts and administrative agencies generally examine:

(i) Common ownership or financial control;

(ii) Common management;

(iii) The interrelation of operations, including the interchange of employees; and

(iv) Common control of labor relations.

(b) Court decisions indicate that ownership in excess of 50 percent may be required to have common ownership. Most courts, including the Court of Appeals for the Second Circuit in New York, have taken a purposefully broad approach to the alter ego theory of holding employers liable for pension obligations. Alter egos exist when the businesses at issue have "substantially identical management, business purpose, operation, equipment, customers, supervision, and ownership," although each factor need not be present. *Lihli Fashions Corp. v. NLRB*, 80 F.3d 743, 747-48 (2d Cir. 1996). *See* e.g., *Burke v. Hamilton Installers*, 2006 U.S. Dist. LEXIS 74850 (W.D.N.Y. 2006), *aff'd*, 528 F.3d 108 (2d Cir. 2008) (alter ego liable for withdrawal liability even though not in common control group where it was simply a "disguised continuance" where corporate formalities not observed, same management, similar ownership, etc.).

IV. Bankruptcy Issues

A. Fraudulent transfer risks

1. Purpose

(a) Fraudulent transfer law imposes a substantive prohibition: a company may not dispose of its property with the intent or the effect of placing it beyond the reach of creditors.

(b) To determine whether a transfer can be avoided, courts generally examine the effect of the transfer on the overall value of the transferor's assets — i.e., whether the transfer diminishes the value of the transferor's assets and adversely affects a creditor's ability to obtain payment of its debt. The focus is from the creditor's perspective as to what the transferor surrendered (or what obligation it incurred) and what the transferor received.

2. Commonly attacked transfers

   (a) Liens granted to lenders in LBO or dividend recapitalization

   (b) Loan obligations incurred to lenders in LBO or dividend recapitalization

   (c) Distributions/dividends paid to shareholders/sponsors

   (d) Management fees

3. Governing law and reach-back period

   (a) Transfers and obligations can be avoided under state law or, in the event of a bankruptcy filing by the transferor, the Bankruptcy Code. There are some differences between state law and Bankruptcy Code, but the laws are generally similar.

   (b) The Bankruptcy Code allows the plaintiff to unwind transfers that occurred within two years of the bankruptcy filing. The reach-back period under state law varies from four years (Delaware) to six years (New York).

4. Actual fraudulent transfer

   (a) A transfer of an interest in property (or the incurrence of an obligation) may be avoidable if the transferor made the transfer (or incurred the obligation) with the "actual intent to hinder, delay or defraud" any creditor of the transferor. *See* Bankruptcy Code § 548(a)(1)(A).

   (b) Whether a debtor actually intended to hinder, delay or defraud creditors by effecting a transfer is a question of fact to be determined by the circumstances of each case. Common indicia of fraudulent intent include:

      (i) Actual or threatened litigation against the debtor;

      (ii) The purported transfer of all or substantially all of the debtor's property;

      (iii) Insolvency or other unmanageable indebtedness on the part of the debtor;

      (iv) A special relationship between the transferee and the debtor; and

      (v) Retention by the debtor of property involved in a putative transfer.

5. Constructive fraudulent transfers

   (a) A transfer of an interest in property (or the incurrence of an obligation) can also be avoided as a so-called "constructive fraudulent transfer" if: (i) the transfer was made while the transferor was insolvent, or if as a result of the transfer the transferor was either rendered insolvent or left with unreasonably small capital; *and* (ii) the transferor received less than reasonably equivalent value in exchange for such transfer. *See* Bankruptcy Code § 548(a)(1)(B). The issues of insolvency, unreasonably small capital and reasonably equivalent value are fact-intensive inquiries.

6. Recovery

   (a) Once a transfer is avoided (under the Bankruptcy Code or applicable state law), the property or the value of such property can be recovered, for the benefit of the estate, from: (i) "the initial transferee of the transfer or the entity for whose benefit the transfer was made;" or (ii) a subsequent transferee. *See* Bankruptcy Code § 550(a).

(b) Even though recovery can be sought from multiple transferees, the estate is entitled to only a single satisfaction. *See* Bankruptcy Code § 550(d).

7. Defenses for a subsequent transferee

(a) A subsequent transferee, unlike an initial transferee, can defend against a fraudulent transfer suit by demonstrating that it paid "value," acted in "good faith" and accepted the transfer "without knowledge of the voidability of the transfer avoided." *See* 11 U.S.C. § 550(b)(1).

(b) To prove good faith, a subsequent transferee must demonstrate that it did not orchestrate the transfer through an innocent third party and, thereby, "wash" the transaction. To prove that it acted "without knowledge of the voidability of the transfer," a subsequent transferee must demonstrate that it did not know facts that would lead a reasonable person to believe that the property transferred was recoverable.

8. Insolvency tests

(a) "Insolvent" is defined in the Bankruptcy Code as a "financial condition such that the sum of such entity's debts is greater than all of such entity's property at a fair valuation." State law definitions are generally consistent.

(b) Generally accepted valuation standards and methodologies recognize three approaches to determine whether a private operating company is solvent for fraudulent transfer purposes: (i) discounted cash flow ("DCF") method; (ii) guideline public company method (also known as the comparable company method); and (iii) recent transaction method (also known as the comparable transaction method). The leading authorities on business valuation recognize that the most reliable method is the DCF method. For public companies, some courts will use the company's market capitalization as evidence of its solvency.

(c) Some courts also use the so-called "adjusted balance sheet test," which involves comparing a debtor's individual assets (as adjusted to reflect their fair value) and liabilities (generally at face value) to determine whether assets exceed liabilities. The balance sheet generally is the starting point for experts' analyses. Courts will not accept a balance sheet on its face; unadjusted balance sheets prepared according to generally accepted accounting principles ("GAAP") are imperfect for the purposes of a bankruptcy insolvency analysis. The accounting conventions are not the controlling principles for the determination of whether a debtor's debts exceed the fair value of its assets for purposes of insolvency because GAAP balance sheets do not reflect an asset's fair value.

9. Adequate capital test

(a) The concept of "unreasonably small capital" is not defined in the Bankruptcy Code or state law. The concept refers to the inability to generate sufficient profits to sustain operations. Courts have held that unreasonably small capital is based on "reasonable foreseeability;" i.e., was it reasonably foreseeable that the company would not be able to sustain operations, given its capitalization level after the transfer. Generally, courts compare a company's projected cash inflows with the company's capital needs throughout a reasonable period of time after the questioned transfer.

(b) The starting place to determine adequacy of capital is the financial projections prepared at the time of the transaction. Because projections tend to be optimistic, their reasonableness must be tested.

10. Risk mitigation

(a) Solvency opinion and independent directors; detailed multi-year projections (base-case and down-side scenarios) with clear explanation of reasonableness of underlying assumptions.

B. Lending to a portfolio company

1. When a sponsor makes a loan to its portfolio company there is litigation risk that: (i) the loan can be recharacterized as equity instead of debt; and (ii) the loan can be subordinated to the claims of general unsecured creditors. Each theory is discussed below.

2. Recharacterization

(a) The doctrine of recharacterization is invoked when a creditor has provided funds to a debtor in the form of a loan or debt investment, but the investment has the substance and character of an equity contribution. The consequence of recharacterization is very significant because equity security holders do not receive any distributions on account of their equity interests unless and until all administrative claims, secured claims and unsecured claims are paid in full.

(b) Generally, but not uniformly, courts have used the following factors to determine whether a claim should be recharacterized as equity:

(i) Names given to instruments evidencing the indebtedness;

(ii) Presence or absence of a fixed maturity date and schedule of payments;

(iii) Presence or absence of a fixed interest rate and interest payments;

(iv) Source of payments;

(v) Adequacy or inadequacy of capitalization;

(vi) Identity of interest between creditor and stockholder;

(vii) Security for the advances;

(viii) Borrower's ability to obtain financing from outside lending institutions;

(ix) Extent to which the advances were subordinated to the claims of outside creditors;

(x) Extent to which the advances were used to acquire capital assets; and

(xi) The presence or absence of a sinking fund to provide repayments.

(c) No one factor is decisive. Generally, the more a debt financing transaction resembles an arm's length negotiation, the more likely it will be treated as a debt.

3. Equitable subordination

(a) Equitable subordination is a judicially-created doctrine (codified in 11 U.S.C. § 510(b)), which allows a court to subordinate, for purpose of distribution, all or part of an allowed claim of a creditor to the claims of other creditors. A party seeking to equitably subordinate a claim has the burden to show that:

(i) A claim holder engaged in inequitable conduct;

(ii) Misconduct caused injury to a creditor or conferred an unfair advantage to the claim holder; and

(iii) Equitable subordination of the claim is consistent with Bankruptcy Code provisions.

(b) There is a minority of courts that have subordinated claims without a finding that the claimant behaved inequitably. Accordingly, it is possible that a court may order equitable subordination even without misconduct because the nature of creditors' claim warrants subordination in order to reach an equitable result.

4. Insider status

(a) The risk of either equitable subordination or recharacterization is increased if the claimant is an insider of the debtor.

(b) Section 101(31) of the Bankruptcy Code defines insider (when the debtor is a partnership) as "(i) the general partner of the debtor; (ii) a relative of a general partner in, general partner of, or person in control of, the debtor; (iii) partnership in which the debtor is a general partner; (iv) a general partner of the debtor; or (v) a person in control of the debtor." Additionally, insider includes affiliates and insiders of affiliates. "Affiliate," in turn, is defined to include an "entity that directly or indirectly owns or controls, or holds with power to vote, 20 percent or more of the voting securities of the debtor…." 11 U.S.C. § 101(2).

C. Breach of fiduciary duty

1. Threshold issues

(a) D&O fiduciary duties must be evaluated according to whether the challenged act or omission occurred when the company was solvent or insolvent. In each instance, one must evaluate the nature of the duty, the beneficiaries and standing to seek redress for a breach.

2. Solvent company

(a) Directors of a solvent company owe a duty of care, good faith and loyalty to the company and its shareholders. Officers, as well as directors, owe fiduciary duties to the company and its shareholders when they have authority in the relevant functional area and the ability to cause or prevent the complained of action.

(b) D&Os of a solvent company owe no fiduciary duties to creditors. Instead, the relationship between the corporation and its creditors is purely contractual and no duties will be imposed beyond those stated in the contract and good faith and fair dealing covenants, which are implied in all contracts.

3. Insolvent company

(a) As the company's financial health deteriorates into insolvency, D&Os owe fiduciary duties to the corporation's creditors. Courts disagree about the scope of these duties and whether the business judgment rule applies to decisions of D&Os of an insolvent company.

(b) Some courts hold that D&Os of insolvent companies owe creditors the same duties of care, good faith and loyalty as the D&Os owed to shareholders and the company when the corporation was solvent, and are entitled to the presumptions of the business judgment rule.

(c) Other courts have held that D&Os of an insolvent company are trustees or "quasi-trustees" for the corporation's creditors. As "quasi-trustees," according to trust law principles, D&Os of an insolvent corporation would be required "to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property."

(d) This standard is stricter than the traditional duty of care to act as a reasonable person would in similar circumstances and may subject D&Os to personal liability for harm to creditors resulting from mere negligence, not gross negligence.

(e) When duties to creditors arise, courts also disagree about whether D&Os continue to owe fiduciary duties to shareholders. Most courts hold that D&Os of an insolvent company continue to owe fiduciary duties to shareholders after a duty to creditors arises, but some suggest that once a company is insolvent, D&Os no longer represent shareholder interests. In those jurisdictions where dual duties are recognized, D&Os of an insolvent corporation may, in certain circumstances, face a dilemma of how to serve the conflicting interests of two distinct constituents.

4. Risk mitigation

(a) Managing a financially troubled company creates substantial risks for D&Os. Every decision during this critical time will be second-guessed. If the trouble signs are present (e.g., defaults on credit facility, cash flow problems, operational difficulties, creditor pressure, risk of significant legal action), the board should meet regularly, closely follow all corporate formalities and strongly consider retaining experienced business, financial, legal advisers and independent directors.

(b) D&Os should also think carefully about the level of detail of board minutes and evidencing that they have satisfied their fiduciary duties.

5. "Deepening insolvency"

(a) Out-of-the-money constituents often invoke the theory of "deepening insolvency" as a weapon to use in their perennial search for deep pockets to enhance recoveries in bankruptcy cases.

(b) Deepening insolvency has been rejected as an independent tort.

Courts, however, have recognized the theory as an *injury* to a corporation for acts that independently constitute wrongful conduct. For example, if a director participated in a fraudulent scheme to raise money by intentionally concealing the company's insolvency from investors, the director might be sued for damages resulting from, among other things, the prolonging of the company's life beyond insolvency and the deepening of its insolvency through increased exposure to creditor liability. Deepening insolvency has been used by plaintiffs as measure of damages in a breach of fiduciary duty claims.

APPENDIX

A. Rules for determining ownership (Reg. § 1.414(c)-4)

1. Constructive ownership: a person having an option to acquire any outstanding interest is considered as owning that interest. (Reg. § 1.414(c)-4(b)).

   Most common attribution rules:

   (a) Partnerships: an "interest owned, directly or indirectly, by or for a partnership shall be considered as owned by any partner having an interest of five percent or more in either the profits or capital of the partnership in proportion to such partner's interest in the profits or capital, whichever such proportion is greater." (Reg. § 1.414(c)-4(b)(2)).

   (b) Estates or trusts: an interest owned, directly or indirectly, by or for an estate or trust shall be considered as owned by any beneficiary of the estate/trust having an actuarial interest of five percent or more in the interest, to the extent of that interest (Reg. § 1.414(c)-4(b)(3)) (Specific rules apply to determining the actuarial interest and special rules apply to estates).

   (c) Spouses: a spouse (with the exception explained below) is considered to own an interest that is owned, directly or indirectly, by or for his/her spouse (this does not include legally separated spouses). (Reg. § 1.414(c)-4(b)(5)) An exception applies if: (i) an individual does not own directly any interest in such organization; (ii) the individual is not a member of the board of directors, a fiduciary, or an employee of such organization and does not participate in the management of such organization; (iii) not more than 50 percent of such organization's gross income for such taxable year was derived from royalties, rents, dividends, interest, and annuities; and (iv) such interest in such organization is not, subject to conditions which substantially restrict or limit the spouse's right to dispose of such interest and which run in favor of the individual or the individual's children who have not attained the age of 21 years.

   (d) Minors: an individual shall be considered to own an interest owned, directly or indirectly, by or for the individual's children who have not attained the age of 21 years, and if the individual has not attained the age of 21 years, an interest owned, directly or indirectly, by or for the individual's parents.

   (e) Children, grandchildren, parents, and grandparents: if an individual is in effective control (i.e., 50 percent control) of an organization, then such individual shall be considered to own an interest in such organization owned, directly or indirectly, by or for the individual's parents, grandparents, grandchildren and children who have attained the age of 21 years.

2. Exclusion of certain interests/stock in determining control (Reg. § 1.414(c)-3): The term "interest" and the term "stock" do not include an interest (directly or with application of certain of the constructive ownership and/or attribution rules) which is treated as not outstanding as provided below. The term "stock" also does not include treasury stock or nonvoting stock, which is limited and preferred as to dividends.

   (a) Parent-subsidiary: if an organization owns 50 percent or more of another organization, then an interest excluded below is treated as not outstanding and is disregarded for purposes of determining if there is a "controlling interest" of 80 percent.

      (i) Plan of deferred compensation: an interest which is an interest in, or stock of, the subsidiary organization held by a trust which is part of a plan of deferred compensation for the benefit of the employees of the parent organization or the subsidiary organization is excluded.

(ii) Principal owners, officers, partners, fiduciaries: an interest which is an interest in, or stock of, the subsidiary organization by an individual who is a principal owner (i.e., five percent or more), officer, partner, or fiduciary of the parent organization is excluded.

(iii) Employees: an interest which is an interest in, or stock of, the subsidiary organization owned by an employee of the subsidiary organization is excluded if such interest or such stock is subject to conditions which substantially restrict or limit the employee's right (or if the employee constructively owns such interest or such stock, the direct or record owner's right) to dispose of such interest or such stock and which run in favor of the parent or subsidiary organization.

The "substantial conditions" on employee interests that warrant their exclusion from the control group analysis include a right of first refusal or a restriction on disposal without consent of another person that runs in favor of the other person. A concession as to price is not necessary. (Reg. § 1.414(c)-3(d)(6)). If a condition which restricts or limits an employee's right (or direct- or record-owner's right) to dispose of his or her interest or stock also applies to the interest or stock in such organization held by a common owner pursuant to a bona fide reciprocal purchase arrangement, such condition is not treated as a substantial limitation or restriction. An example of a reciprocal purchase arrangement is an agreement whereby a common owner and the employee are given a right of first refusal with respect to stock of the employer corporation owned by the other party. If, however, the agreement also provides that the common owner has the right to purchase the stock of the employer corporation owned by the employee in the event the corporation should discharge the employee for reasonable cause, the purchase arrangement would not be reciprocal.

Special rules also apply to tax-exempt educational and charitable organizations.

(b) Brother-sister: if five or fewer individuals, estates or trusts own 50 percent or more of another organization, then an interest excluded below is treated as not outstanding and is disregarded for purposes of determining if there is a "controlling interest" of 80 percent or "effective control" of more than 50 percent.

(i) Employee benefit plan trust: an interest or stock owned by an employee benefit plan trust exempt from taxation is excluded if such trust is for the benefit of the employees of such organization.

(ii) Employees: an interest which is an interest in, or stock of, such organization owned by an employee of such organization is excluded if such interest or such stock is subject to conditions which substantially restrict or limit the employee's right (or if the employee constructively owns such interest or such stock, the direct or record owner's right) to dispose of such interest or such stock. *See* above discussion of "substantial conditions."

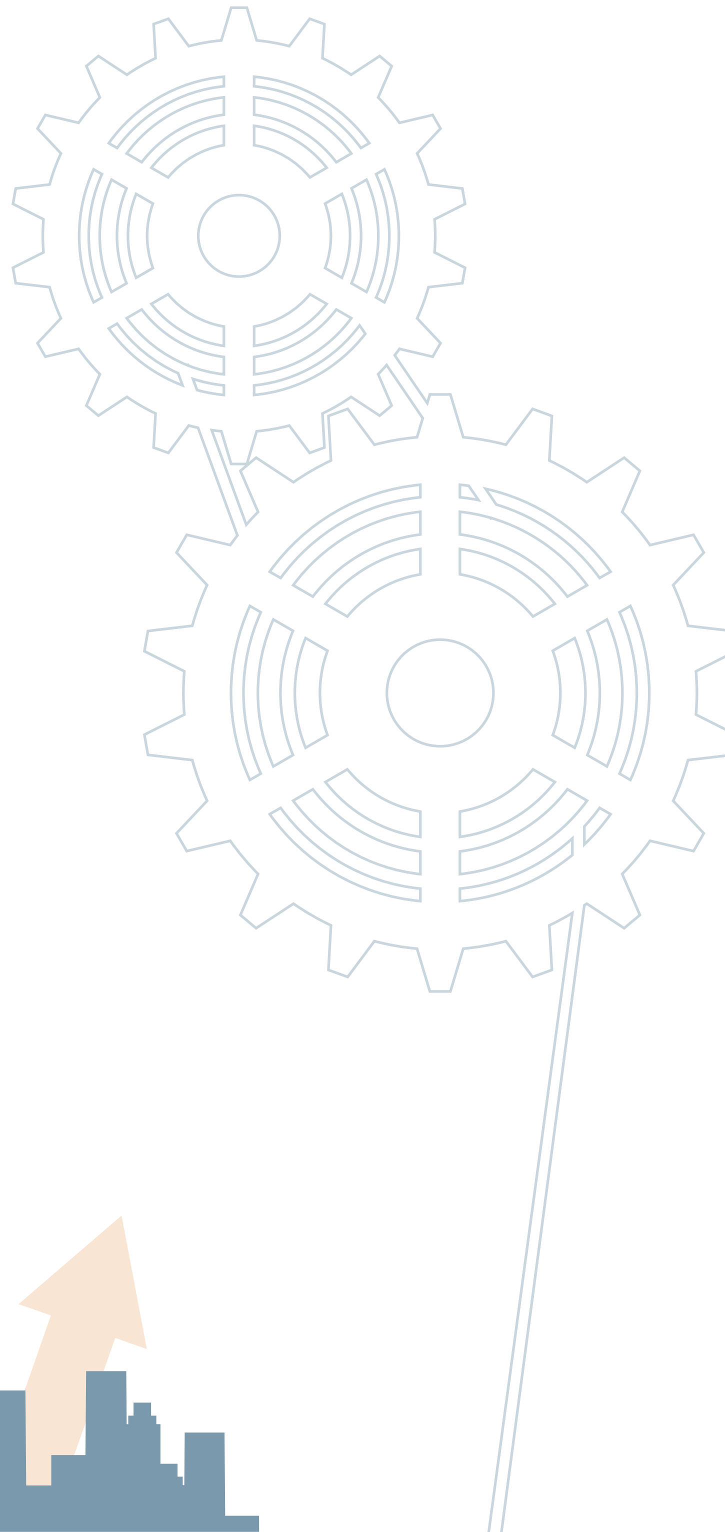
Special rules also apply to tax-exempt educational and charitable organizations.

Schulte Roth & Zabel

Form PF Workshop

Speakers

Kristin Boggiano
Daniel Hunter
Jason Kaplan



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Dan 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, merger and acquisition and restructuring advice to his fund clients, and advises funds regarding the receipt or allocation of seed capital. As part of his compliance practice, Dan advises clients on the Treasury Forms (TIC Forms), the CFTC rules and regulations, as well as the recently adopted Form PF.

A sought-after speaker, Dan recently discussed “New Private Placement Rules Under the JOBS Act” at a Financial Executives Alliance event and presented “Compliance and CFTC Issues for Brazilian Managers” at the Goldman Sachs *Prime Brokerage Conference* in São Paulo. Additionally, he co-authored “New European Rules on Short Selling — Effective 1 November 2012,” which was published in *The Hedge Fund Journal*. Dan has been recognized in *The Legal 500 USA* in the Investment Fund Formation and Management category.

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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Jason S. Kaplan

Jason concentrates on investment management and related regulatory and compliance matters, advising on general corporate, securities and compliance issues for investment advisers and investment funds. Jason's practice focuses on advising managers of hedge, private equity and hybrid funds regarding the structure of their businesses and on day-to-day operational, securities, corporate and compliance issues; structuring and negotiating seed and strategic investments and relationships; and advising investment managers with respect to regulatory and compliance issues.

Among recent speaking and writing engagements, Jason participated in the "Form PF Masterclass" at Credit Suisse's *European Hedge Fund Thought Leadership Conference* and presented at the "Prime Brokerage Form PF Workshop" as part of a Goldman Sachs seminar. He also co-authored "Dodd-Frank Becomes Law: Key Issues for Private Fund Managers" for *The Hedge Fund Journal*.

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.

Kristin Boggiano

Daniel F. Hunter

Jason S. Kaplan

Form PF Workshop

Notes:

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I. Overview

The Securities and Exchange Commission adopted Rule 204(b)-1 under the Investment Advisers Act of 1940, requiring registered investment advisers to report detailed financial, portfolio and operational information about their private funds on Form PF. In addition, the Commodity Futures Trading Commission ("CFTC") adopted Sections 1 and 2 of Form PF and Rule 4.27 under the Commodity Exchange Act, requiring commodity pool operators ("CPOs") and commodity trading advisors ("CTAs") registered with the CFTC to report on Form PF.[1]

II. Due Date for Filings

A. Filing dates applicable to firms with a December 31 fiscal year-end are as follows:

Fund Size	Frequency	Next Filing Date
Large hedge fund advisers	Quarterly, within 60 days of quarter-end	March 1
Large private equity fund advisers	Annually, within 120 days of year-end	April 30
Large liquidity fund advisers	Quarterly, within 15 days of quarter-end	January 15
All other funds	Annually, within 120 days of year-end	April 30

B. Who needs to file: an investment adviser must file Form PF if it: (1) is registered or required to register with the SEC; (2) advises one or more private funds; and (3) had at least $150 million in regulatory assets under management attributable to private funds as of the end of its most recently completed fiscal year.

C. Exempt advisers: exempt advisers do not have to file Form PF. Exempt advisers include private fund advisers that do not have to register with the SEC because they rely upon the private fund adviser exemption (e.g., non-U.S. advisers relying on that exemption).

III. Definitions

A. Large private fund adviser: definition of a "large private fund adviser" for hedge funds, private equity funds and liquidity funds

1. Hedge funds: 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 adviser's most recently completed fiscal quarter. Accordingly, for funds with a fiscal year-end on Dec. 31, 2012, the adviser would measure the assets as of the last day of July, August and September to determine if there is a filing due by March 1, 2013.

2. Private equity funds: advisers with at least $2 billion in regulatory assets under management attributable to private equity funds as of the last day of such adviser's most recently completed fiscal year. Accordingly, for these funds with a fiscal year-end on Dec. 31, 2012, the adviser would measure the assets as of December 31 to determine if there is a filing due by April 30, 2013.

[1] Form PF is a joint form between the SEC and the CFTC only with respect to sections 1 and 2 of the form. Sections 3 and 4 of the form are adopted solely by the SEC.

3. Liquidity funds: 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 adviser's most recently completed fiscal quarter. Accordingly, for funds with a fiscal year-end on Dec. 31, 2012, the adviser would measure the assets as of the last day of July, August and September to determine if there is a filing due by Jan. 15, 2013.

B. Hedge fund: definition of a "hedge fund"

Form PF defines "hedge fund" to include any private fund having any one of the following characteristics of a hedge fund:

1. A performance fee or allocation that is based on market value (and not solely on realized gains);

2. 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

3. 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).

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. Liquidity fund: definition of a "liquidity fund"

Form PF defines a "liquidity fund" as any private fund that seeks to generate income by investing in a portfolio of short-term obligations in order to maintain a stable net asset value per unit or to minimize principal volatility for investors (e.g., a private money market fund).

D. Private equity fund: definition of 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.

IV. Accuracy of Data

A. SEC standard: a "willful misstatement or omission of a material fact" in any report filed with the SEC under the Advisers Act is unlawful. Instruction 16 to Form PF explains that an adviser is not required to update information that it believes in good faith properly responded to Form PF on the date of filing even if that information is subsequently revised for purposes of the adviser's recordkeeping, risk management or investor reporting (such as estimates that are refined after completion of a subsequent audit).

B. CFTC standard: any "false or misleading statement of material fact or material omission" in (sections 1 or 2) of Form PF that is filed by a CPO/CTA shall constitute a violation of section 6(c)(2) of the CEA.

V. Lessons Learned From First Filers

A. Have a team leader: establish a designated person that coordinates data from operations, legal, treasury, information technology, traders, service providers, investor relations and accountants.

1. Create clear roles and appoint people to monitor and complete different categories of Form PF related to their role.

2. Consider the right approach for your firm, which may include the purchase of software or use of consultants.

B. Third-party service providers: it is important to review the output provided by the service providers to ensure that the work product is consistent with the overall approach of how you are presenting the adviser and the fund. For example, if a service provider is providing data on performance, make sure that the performance numbers are consistent with the periodic reporting sent to investors. Ultimately, you are responsible for the work product and while third-party service providers are valuable, you need to ensure that the information that they produce is correct for your firm.

C. Consistent but flexible: develop a controlled process that can be repeated over time, but is flexible enough to incorporate changes that may be required through guidance from the regulators.

D. File early: many early filers had their initial submissions rejected due to technical issues with the filing system. Testing filing in advance of the due date helps managers work through technical issues.

VI. Information Required by Form PF

A. Section 1a: required for all advisers

Section 1a generally requires information about the identity of the adviser and its related persons, amount of regulatory AUM and net AUM attributable to various fund types.

B. Section 1b: required for each private fund

Advisers will have to fill out this section multiple times if they manage multiple private funds that are not parallel funds or part of a single master-feeder structure.

1. Section 1b generally requires information about the identity of the fund, NAV, a breakdown of the fund's borrowing, a breakdown of fund ownership by investor type and net and gross performance (on annual basis, at minimum).

C. Section 1c: required for each hedge fund

Section 1c generally requires information about each hedge fund and its investment strategy, approximate percentage of assets managed using high-frequency trading strategies, disclosure of significant counterparties and information on trading and clearing practices.

D. Section 2a: required for all large hedge fund advisers

Section 2a generally requires aggregate data on exposure by asset class, value of turnover in certain asset classes and geographical breakdown of investments.

E. Section 2b: required for each "qualifying hedge fund"

Section 2b generally requires information about exposure by asset class, value of unencumbered cash, large positions (five percent 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.

1. A "qualifying hedge fund" is a hedge fund with a net asset value of at least $500 million as of the last day of any month in the fiscal quarter immediately preceding such adviser's most recently completed fiscal quarter (note that net asset value generally differs from regulatory assets under management).

2. 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.

3. If you advise only one large hedge fund (or one set 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.

F. Section 3: required for each liquidity fund of a large liquidity fund adviser

Section 3 generally requires information about operations, NAV, maturity profile by instrument, large positions (five percent or more of the fund's NAV) by asset class and as a percentage of NAV and investor concentration and liquidity. Advisers will have to fill out this section multiple times if they manage multiple liquidity funds.

G. Section 4: required for each private equity fund of a large private equity fund adviser

Section 4 generally requires information about guarantees of portfolio company obligations, leverage of portfolio companies the fund controls and 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. Advisers will have to fill out this section multiple times if they manage multiple private equity funds.

VII. Summary of Certain Key Frequently Asked Questions ("FAQs")

A. Categorizing funds

1. Private equity and real estate funds that may be considered hedge funds (Question D.1)

The SEC's FAQs provide guidance that if the fund documents permit the use of leverage or the ability to short (i.e., the "potential use" of shorts) and would therefore qualify under the definition of "hedge fund," reporting advisers may have to report such funds as "hedge funds" even if the fund does not in fact incur leverage or shorts. According to the Form PF SEC adopting release, a private fund would not be a "hedge fund" for purposes of Form PF solely because its fund documents fail to prohibit the fund from the use of leverage or the ability to short, so long as the fund in fact does not engage in these practices (other than with respect to short selling for the purpose of hedging currency exposure or managing duration) *and* a reasonable investor would understand, based on the fund's offering documents, that the fund will not engage in these practices.

2. Funds that meet multiple definitions (Questions C.1 and C.2)

SEC guidance provides that if a fund meets both the definition of a liquidity fund and a hedge fund, it should complete each section applicable to hedge funds and liquidity funds. In addition, the reporting adviser should categorize the fund as "other" on its Form ADV, Schedule D. If the reporting adviser needs to change the categorization of a private fund on its Form ADV, Schedule D, it should file an other-than-annual amendment to its Form ADV to reflect such change before filing Form PF.

B. Counterparty credit exposure (Questions 22, 23, 36 and 37)

With respect to the reporting of counterparty credit exposure in Form PF, the SEC clarified that advisers should only include counterparties for over-the-counter derivative transactions, loans and loan commitments. Advisers should not include assets held in custody at their custodians or prime brokers (except to the extent such assets are held as collateral by such custodians or prime brokers in their capacity as derivative counterparties or lenders), and advisers should not include futures positions or excess margin held at a futures commission merchant.

C. Borrowings (Questions 12, 43, 46, 47 and 58)

The SEC provided guidance on the definition of the term "borrowings," which it interpreted broadly to include certain types of synthetic borrowings. Specific examples of borrowings provided in the FAQs include short sales, securities lending transactions, repos, variation margin owed but not yet paid and certain types of synthetic borrowings.

D. Rehypothecation of collateral and other credit support (Question 38)

Cash collateral should not be included in the questions regarding rehypothecation of collateral and other credit support.

E. Excluding assets of funds of funds (Questions 3, 8, 9 and 10)

For purposes of responding to Questions 3, 8, 9, and 10, if the reporting adviser chooses to exclude disregarded private funds (i.e., funds of funds) and equity investments (in accordance with Instruction 7), then such reporting adviser should exclude disregarded private funds and equity investments with respect to (x) reporting the breakdown of the reporting adviser's regulatory assets under management and net assets in Question 3 and (y) the reporting fund's gross asset value in Question 8 and net asset value in Question 9. However, the reporting adviser is required to report the value of the reporting fund's investments in the equity of other private funds in Question 10, even if the reporting fund is a disregarded private fund.

F. Definition of "net asset value"

The SEC provided guidance that a reporting adviser would not need to deduct the liabilities associated with deferred compensation when calculating a fund's net asset value, provided that the reporting adviser notes such position in Question 4.

G. Stress testing (Question 42)

If a reporting adviser has models or other systems that have the ability to test the factors listed in Question 42, the SEC has provided guidance that such reporting adviser must provide a response relevant to such factor.

H. Legal entity identifier (Question 4)

The SEC states in the FAQs that funds may use the CFTC-issued CFTC Interim Compliant Identifiers ("CICIs") as the Legal Entity Identifier ("LEI") in Form PF. CICIs were created by the CFTC in order to identify entities trading over-the-counter derivatives. CICIs will become the LEIs when the global LEI system is enacted.

VIII. Form CPO-PQR

A. The CFTC finalized rules on Feb. 24, 2012 that require registered CPOs to file Form CPO-PQR. The CFTC rules provide that the frequency of reporting and the amount of information to be included in each report vary in accordance with the CPO's assets under management, although CPOs that are filing Form PF with the SEC are not required to fill out most of Form CPO-PQR. Separately, since 2010, the NFA has its own PQR (pool quarterly reports), pursuant to NFA Rule 2-46. Rule 2-46 requires CPOs to submit a Schedule of Investments (which included positions that exceed 10 percent of NAV but now requires positions which exceed five percent of NAV) together with other information similar to Schedule A of the CPO-PQR. The NFA has merged the two requirements, i.e., Rule 2-46 with the CFTC CPO-PQR requirement, to require one filing for both requirements (although it is still in the process of formally finalizing this merger) as follows: Form PF filers will be required to file Schedule A and a Schedule of Investments on a quarterly basis, within 60 days of quarter end and within 90 days of year-end.

B. The CFTC requires commodity trading advisors ("CTAs") to file Form CTA-PR on an annual basis, although the NFA is proposing to add its own PR filing requirement which will essentially be requiring this filing from all CTAs on a quarterly basis. There is no Form PF exemption from the Form CTA-PR requirement.

C. Most new CFTC registrants were only registered as of January 1. Those CPOs and CTAs have no requirements with respect to 2012 and the first filing requirement will be for the first quarter of 2013 (i.e., due by May 2013).

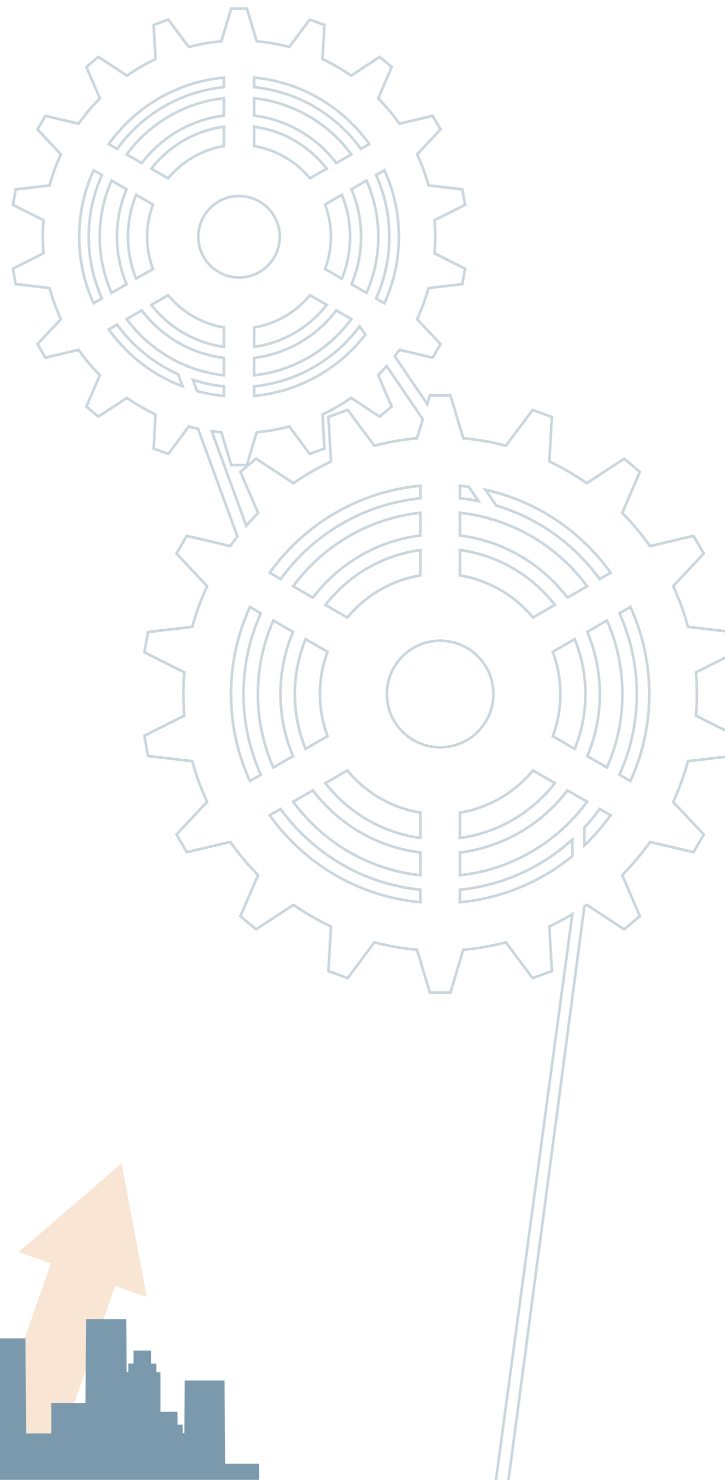
D. Given the little guidance provided for the forms, the CFTC is allowing "reasonable assumptions" to be made in filling out the forms. The CFTC is expected to release revised guidance at some point this year which is expected to provide additional clarity on issues such as AUM calculations, how to treat fund of funds investments, side-by-side structures, master feeder structures and SPVs.

Schulte Roth & Zabel

FCPA Issues for Fund Managers

Speakers

David Rosewater
Gary Stein
Peter White



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David focuses his practice on mergers and acquisitions, private equity/leveraged buyouts, distressed investments and acquisitions, and shareholder activism. He has represented numerous corporate and private equity buyers and sellers, including in connection with the acquisitions of AT&T Advertising and Interactive Business Solutions, which was named the 2012 "North American Private Equity Deal of the Year" by Global M&A Network, and 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.

David's other acquisition-related representations include deals involving 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 also represented companies and shareholders in connection with a number of major campaigns, including those involving BMC Software, Wet Seal, The New York Times Co., Marathon Petroleum, CSX Corp., Red Robin Gourmet Burgers Inc., Allscripts and Mentor Graphics Inc.

David frequently writes and speaks in his areas of expertise. He is the co-author of the U.S. chapter of *The International Comparative Guide to: Corporate Governance 2012* (Global Legal Group), as well as SRZ's *Middle Market PE Buyer/Public Target M&A Deal Study*, SRZ's *PE Buyer/Public Target M&A Deal Study: 2012 Mid-Year Update* and "Keeping Up With Distressed Debt Strategies" from *Buyouts*. David also contributed to *Distressed Investing M&A* (in association with mergermarket and Debtwire) and *Shareholder Activism Insight*, an annual report created in association with mergermarket. David's recent presentations at industry events include participating in the Norton Rose *3rd Annual Shareholder Activism in Canada Seminar* and in "M&A Update — Experts Discuss Today's Dealmaking Climate" at Thomson Reuters' *Buyouts Texas* conference.

David received his J.D., *cum laude*, from New York University School of Law and his B.A., with distinction and high honors, from the University of Michigan.

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Gary focuses on white-collar criminal defense and securities regulatory matters, complex commercial litigation, internal investigations, anti-money laundering issues, civil and criminal forfeiture proceedings and appellate litigation. He represents public companies, financial institutions, hedge funds, other entities and individuals as subjects, victims and witnesses in federal and state criminal investigations and regulatory investigations by the SEC, SROs and state attorneys general. He has conducted numerous internal investigations involving potential violations of the Foreign Corrupt Practices Act, financial statement fraud, money laundering and other matters, and advises companies on compliance with the FCPA, 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 authored "Forfeiture: A Primer on Proceeds" in the *Business Crimes Bulletin* and 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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Pete represents 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. He 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 and compliance law); *Ethisphere: Attorneys Who Matter*; *Washington, DC Super Lawyers*; *Washingtonian Magazine* (white collar defense) and *The Washington Post* ("Their Own Defense," June 18, 2007).

Pete regularly speaks and writes, recently authoring the chapter on "Civil and Criminal Enforcement" in the *Insider Trading Law and Compliance Answer Book* published by Practising Law Institute and co-authoring "Recent FCPA Developments Highlight Risk of Individual Liability" for the *Financial Fraud Law Report*. He also spoke on "Retaining Counsel, the Search, and Investigating the Case" and "Handling the Search" at the National Association of Criminal Defense Lawyers' *White Collar Criminal Defense College* and participated in the SRZ *Investment Management Hot Topics* seminar titled "The Foreign Corrupt Practice Act: How Funds Can Mitigate Risks."

Pete obtained his J.D. from The University of Virginia School of Law, where he was Order of the Coif and served 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. He obtained his B.A., with high honors, from the University of Notre Dame.

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FCPA Issues for Fund Managers

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FCPA Issues for Fund Managers

I. Why Investment Funds Should Care About the FCPA

A. Most funds have some FCPA risk; some funds have a lot of FCPA risk.

B. The FCPA has broad extraterritorial reach.

C. The U.S. government has been very aggressive in this area.

D. The consequences of an FCPA violation — or merely an allegation of an FCPA violation — are serious.

E. Counterparties care about the FCPA.

F. Anti-corruption efforts have now gone global — other countries and international organizations have already passed and will continue to pass similarly aggressive anti-bribery laws (e.g., U.K. Anti-Bribery Act; EU; OAS; World Bank; IMF; OECD Convention on Combating Bribery of Foreign Officials in International Business Transactions).[1]

II. What Is the FCPA?

A. Federal statute passed by post-Watergate Congress in 1977

B. Two prongs

1. Anti-bribery provisions: prohibit "offering to pay, paying, promising to pay, or authorizing the payment of money or anything of value (tangible or intangible) to a foreign official in order to influence any act or decision of the foreign official in his or her official capacity or to secure any other improper advantage in order to obtain or retain business."

   (a) Apply to bribes paid directly and bribes paid indirectly through third-party intermediaries (e.g., agents, placement agents, sub-agents, consultants, representatives, distributors, resellers, introducers/finders, joint venture partners, brokers, contractors, lawyers, accountants, lobbyists).

2. Accounting provisions: require issuers to maintain accurate books and records and establish a system of internal controls.

   (a) Apply only to Issuers (but an issuer's books and records include those of its consolidated subsidiaries and affiliates under its control, including foreign subsidiaries and joint venture partners).

   (b) Do not apply merely because a fund is registered with the SEC, so they are usually not an issue for private investment funds. However, they do apply to portfolio companies that are publicly traded, whether in equity or debt markets.

C. Enforced by DOJ and SEC: penalties are harsh.

1. Criminal penalties for violating the anti-bribery provisions.

   (a) Corporate fine up to $2 million for each violation.

[1] *Note*: While the FCPA only prohibits the bribery of foreign officials, bribery in the private sector may violate other laws, such as: the Travel Act (18 U.S.C. § 1952), the U.S. mail and wire fraud statutes (18 U.S.C. §§ 1341, 1343, 1346), the anti-money laundering laws (18 U.S.C. §§ 1956-1957), the U.K. Bribery Act of 2010, the United Nations Convention Against Corruption (Dec. 11, 2003, 43 I.L.M. 37), among others.

(b) Individuals (officers, directors, employees, agents, etc.) can be fined up to $250,000 and imprisoned up to five years for each violation.[2]

(c) Fines can also be up to twice the profit gained from the illegal activity or twice the loss resulting from the illegal activity.

2. Criminal penalties for violating the accounting provisions: corporate fine up to $25 million and individuals up to $5 million and/or 20 years in prison.

3. Civil penalties for violating the anti-bribery provisions may include DOJ and/or SEC obtaining injunctive relief and fines up to $10,000 for each violation ($16,000 adjusted for inflation).

4. Civil penalties for violating the Accounting Provisions may include hefty fines imposed by the SEC or disgorgement of illegal profits.

5. Other adverse consequences include: forfeiture of assets, suspension or disbarment from the securities industry or from contracting with the federal government, cross-debarment by multilateral development banks, the suspension or revocation of certain export privileges, shareholder derivative and class action lawsuits, plus other collateral consequences.

6. *Note*: rewards and protections are available under whistleblower provisions of the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010.

(a) The SEC received more than 3,000 whistleblower tips in FY2012, of which 115, or 3.8 percent, involved FCPA allegations.

III. To Whom Does the FCPA Apply?

Anti-bribery provisions make it illegal for an "issuer," a "domestic concern" or any "other" person to make corrupt payments, directly or indirectly, to a foreign government official in order to obtain, retain or direct business. 15 U.S.C. §§ 78dd-1, 2 and 3.

A. "Issuer"

1. Issuers with a class of securities registered under the Securities Exchange Act of 1934.

2. Includes foreign companies with U.S. ADRs.

B. "Domestic concern"

1. U.S. citizens, nationals and residents.

2. Companies that have their principal place of business in the United States or are organized under U.S. law.

C. Any "other" person (i.e., non-U.S. persons)

1. May be liable if they commit any act in furtherance of an unlawful payment while in the territory of the United States ("territorial jurisdiction"), including (according to the DOJ) "causing" an act in the United States, directly or through agents.

D. Foreign subsidiaries (U.S. parents may be held liable for acts of foreign subsidiaries if they participated in or directed the illegal activity, or, under agency principles, if the requisite degree of control exists over the subsidiary's actions.)

[2] Fines on individuals cannot be paid by the corporation. 15 U.S.C. § 78dd-2(g)(3).

E. Related persons (i.e., officers, directors, employees or agents of a U.S. issuer or domestic concern or a covered non-U.S. company, or any stockholder acting on their behalf)

F. SEC's "control person" theory of liability

1. Under § 15 of the Securities Act of 1933 (15 U.S.C.A. § 77o) and § 20(a) of the Securities Exchange Act of 1934 (15 U.S.C.A. § 78t(a)), liability for a securities law violation may be imposed not only on the person who actually commits the violation but also on an entity or individual that "controls" the violator (directly or indirectly, via stock ownership, agency, or otherwise).

2. Control person liability creates potential exposure for investment funds and their personnel to the extent they exercise control over a portfolio company that is a U.S. Issuer by virtue of ownership interest, Board representation, and/or involvement in management and financial reporting.

   (a) *E.g.*, a private investment fund that controlled a U.S. issuer that engaged in FCPA violations could face liability under this theory.

3. *SEC v. Nature's Sunshine Products, Inc., Douglas Faggioli and Craig D. Huff*, Case No. 09CV672 (D. Utah, Filed July 31, 2009) (the SEC charged two top executives of a U.S. issuer, in their capacity as control persons, with books and records and internal control violations,— the SEC's theory was that the CEO and CFO failed to adequately supervise Nature's Sunshine personnel).

IV. Elements of an FCPA Violation

A. Payment or offer

1. Of money or "anything of value" (no monetary threshold)

2. Offer, promise or authorization of a payment is enough to violate the FCPA, even if no payment has yet been made.

B. Prohibited recipient

1. "Foreign official" (i.e., "[a]ny officer or employee of a foreign government or any department, agency or instrumentality thereof, or any person acting in an official capacity for or on behalf of any such government or department, agency or instrumentality")

   (a) According to the DOJ/SEC, the instrumentality prong includes employees of state-owned entities or state-controlled entities ("SOEs"), even those SOEs engaged in commercial activities.[3]

2. Officials of a "public international organization" (e.g., UN, World Bank)

3. Foreign political parties, officials of foreign political parties and candidates for foreign political office

[3] According to the DOJ/SEC, whether a particular entity constitutes an "instrumentality" under the FCPA requires a fact-specific analysis of an entity's ownership, control, status and function. A non-dispositive and non-exclusive list of factors to consider includes: "(1) the foreign state's extent of ownership of the entity; (2) the foreign state's degree of control over the entity (including whether key officers and directors of the entity are, or are appointed by, government officials); (3) the foreign state's characterization of the entity and its employees; (4) the circumstances surrounding the entity's creation; (5) the purpose of the entity's activities; (6) the entity's obligations and privileges under the foreign state's law; (7) the exclusive or controlling power vested in the entity to administer its designated functions; (8) the level of financial support by the foreign state (including subsidies, special tax treatment, government-mandated fees and loans); (9) the entity's provision of services to the jurisdiction's residents; (10) whether the governmental end or purpose sought to be achieved is expressed in the policies of the foreign government; and (11) the general perception that the entity is performing official or governmental functions." While the DOJ/SEC have provided guidance that "an entity is unlikely to qualify as an instrumentality if a government does not own or control a majority of its shares," DOJ/SEC enforcement actions have, in limited circumstances, involved foreign officials employed by SOE in which a foreign government has less than 50 percent ownership (i.e., only where the foreign government has "substantial control" over the SOE at issue).

4. Any person acting as a conduit for payments to any of the above

C. Corrupt intent

Payment must be for the purpose of:

1. Influencing any act or decision of a foreign official in his or her official capacity;

2. Inducing such foreign official to do or omit to do any act in violation of the lawful duty of such official;

3. Securing any improper advantage; or

4. Inducing such foreign official to use his or her influence with a foreign government or instrumentality to affect or influence any act or decision of such government or instrumentality.

D. Business purpose requirement

1. Payment must be made for the purpose of assisting the violating party in obtaining or retaining business for or with, or directing business to, any person.

2. Such business does not need to be with a foreign government or foreign government instrumentality.

E. Jurisdiction

1. U.S. issuers, U.S. companies and U.S. individuals liable for prohibited acts committed anywhere in the world, regardless if there is a nexus to the United States.

2. Non-U.S. persons liable (as noted above) for prohibited acts committed while in the territory of the United States ("territorial jurisdiction"), including (according to the DOJ) "causing" an act in the United States.

V. Common Misconceptions About the FCPA

A. The FCPA only applies if the recipient of the bribe is a high-ranking foreign official (e.g., a minister).

Wrong: The FCPA defines a foreign official as "any officer or employee of any government or agency, department or instrumentality." U.S. officials take the position that this includes low-level officials and all employees of state-owned companies. *United States v. Aguilar*, 783 F. Supp. 2d 1108 (C.D. Cal. 2011) (holding that FCPA's definition of foreign official can include employees of state-owned business enterprises).

B. If I don't actually know that a bribe is being paid, I haven't violated the FCPA.

Wrong: Prosecutors can and frequently do pursue FCPA cases on a "willful blindness" or "deliberate ignorance" theory. That theory permits the imposition of liability even where the defendant did not have actual knowledge that a bribe was being paid, if he or she was aware of a "high probability" that a bribe was being paid, and "consciously avoided" trying to confirm whether that was the case. This often becomes a key issue when dealing with agents, consultants and other third-party intermediaries. *United States v. Kozeny*, 667 F.3d 122 (2d Cir. 2011) (upholding conviction of investor in Azerbaijan privatization venture on "conscious avoidance" theory).

C. It is a defense under the FCPA that the defendant didn't propose the bribe and only paid it after the foreign official solicited the bribe.

Wrong: It doesn't matter who solicited or first suggested the bribe. The scheme does not have to originate with the person making the payment; rather, the anti-bribery provision "cover[s] payments and gifts intended to influence the recipient, regardless of who first suggested the payment or gift." S. Rep. No. 114, 95th Cong., 1st Sess., at 11 (1977).

D. It is a defense under the FCPA that bribery is part of the culture in a foreign country.

Wrong: It is no defense that bribery is customary or pervasive in the country in question. It doesn't matter if this is the way "people do business" in the country.

E. It is a defense under the FCPA that your company had an "adequate compliance program" in place.

Wrong: There is no safe harbor under the FCPA based upon an adequate compliance program. However, the DOJ and SEC may consider the adequacy of a company's compliance program when deciding what, if any, enforcement action to take (declination, NPA, DPA, compliance monitor, civil and/or criminal charges, etc.).

VI. FCPA Risks for Investment Funds

A. Risks in raising money

1. Foreign government investors (e.g., sovereign wealth funds, state-owned pension plans, private pension plans requiring government approval, any other investor owned or controlled by a foreign government)

2. Placement agents and other third-party marketers and intermediaries who help solicit foreign money, especially from foreign government investors

3. Gifts, travel, entertainment ("GTE") involving foreign government investors

Note: What a hedge fund considers "reasonable" in New York may be viewed as "lavish" by the U.S. government.

4. Foreign officials, political leaders or candidates as investors

Note: Beware of "private" parties who are acting on behalf of foreign officials.

B. Risks in making investments

1. Portfolio companies (both U.S. companies that do business overseas and foreign companies)

2. Overseas investments

3. Privatization deals

4. Joint ventures with SOEs

C. Risks in foreign offices/operations

1. Obtaining licenses and permits

2. Regulatory inspections and audits

3. Foreign tax issues

VII. Recent Enforcement Activity/Trends

A. The DOJ and SEC have dramatically stepped up FCPA enforcement in recent years.

B. More cases are being brought.

1. 86 DOJ/SEC enforcement actions in 2006-2008.

2. 162 DOJ/SEC enforcement actions in 2009-2011.

3. But there was a dip in enforcement activity in 2012 — only 23 DOJ/SEC enforcement actions, the fewest since 2006.

C. Higher penalties are being imposed.

1. In the FCPA's first 25 years, only four fines > $1 million.

2. Now, eight- and nine-digit fines are common (largest settlement: $800 million by Siemens).

D. Focus on prosecuting individuals

1. "[O]ne cornerstone of our FCPA enforcement policy [is] the aggressive prosecution of individuals. Put simply, the prospect of significant prison sentences for individuals should make clear to every corporate executive, every board member, and every sales agent that we will seek to hold you personally accountable for FCPA violations." (DOJ, Assistant Attorney General, Lanny Breuer, February 2010).

2. "You're going to see a lot more cases against individuals .... We are continuing to increase our efforts to bring charges against corrupt individuals who have a role in the accounting and control violations that occur." (SEC, Assistant Director of FCPA Unit, Tracy Price, October 2011).

3. E.g., in December 2011, eight former executives and agents of Siemens were charged by DOJ/SEC for engaging in a decade-long scheme to bribe senior Argentine government officials in connection with a $1 billion contract with the Argentine government to produce national identity cards. Further demonstrating the aggressiveness of FCPA enforcement, none of the charged individuals are U.S. citizens or residents. While some of the individuals are settling with the government, others are challenging the DOJ/SEC, and putting the government to its burden of proof.

E. The trend toward increased FCPA enforcement shows no sign of abating.

1. Expansion of FCPA enforcement resources

2. Additional FCPA prosecutors at the DOJ

3. In 2010, the SEC Enforcement Division created a specialized FCPA Unit.

4. More than 150 open FCPA investigations (as of April 2012)

F. Aggressive law enforcement techniques

1. Sting operations

2. Sector-wide probes/sweeps

3. Wiretaps?

G. 2012 DOJ/SEC guidance

1. In November 2012, in an "unprecedented undertaking," the DOJ and SEC issued a 120-page resource guide (the "Guide") on the FCPA, providing the public with interpretations of the law, hypothetical examples and principles of enforcement.

2. The Guide is available at http://www.justice.gov/criminal/fraud/fcpa/guide.pdf.

3. An SRZ *Alert*, discussing the Guide, is available at http://www.srz.com/New_FCPA_Guidance_Highlights_Importance_of_Effective_Compliance_Procedures/.

VIII. Recent Enforcement Actions Focusing on Investment Funds

A. SEC sovereign wealth funds investigation

1. In January 2011, the SEC sent letters to a number of firms to determine whether banks and private equity firms violated the FCPA in their dealings with sovereign wealth funds and state-owned pension plans.

2. No charges announced to date.

B. Azerbaijan privatization case

1. Scheme to bribe senior government officials in Azerbaijan with several hundred million dollars in shares of stock, cash and other gifts intended to influence privatization of State Oil Company.

2. Omega Advisors Inc.

   (a) One of the investment funds that invested in the Azerbaijani privatization program entered into an NPA in July 2007.

   (b) Agreed to civil forfeiture of $500,000.

   (c) Acknowledged that its former employee had learned, prior to its investment, that some Azeri officials had been given a financial interest in the privatization by Viktor Kozeny, the organizer of the investment consortium.

3. *United States v. Bourke* (Frederic A. Bourke Jr.)

   (a) Investor in same Azerbaijani privatization program, convicted after a jury trial in July 2009 of conspiring to violate the FCPA and the Travel Act and of making false statements to the FBI.

   (b) Sentenced in November 2009 to one year and one day in prison.

   (c) Bourke did not pay bribes directly and lost $8 million on deal.

   (d) Jury instructed on "conscious avoidance" theory.

   (e) "We thought [Bourke] knew [about the bribery] and definitely could have known. He's an investor. It's his job to know." (Jury foreman, *U.S. v. Bourke*).

   (f) Bourke's conviction affirmed on appeal in December 2011. Court of Appeals held that evidence was sufficient to establish that Bourke "deliberately avoided confirming his suspicions that Kozeny and his cohorts may be paying bribes."

   (g) Court of Appeals also held that it was proper for prosecutors to argue that "Bourke refrained from asking his attorneys to undertake the same due diligence done by [representatives of another investor, who wound up deciding not to invest] because Bourke was consciously avoiding learning about the bribes."

C. United States v. Peterson and *SEC v. Peterson*

1. In April 2012, the DOJ and SEC announced charges against Garth Peterson, the former managing director of Morgan Stanley's Chinese real estate investment and fund advisory group. Peterson secretly acquired millions of dollars worth of real estate investments for himself and an influential Chinese official who in turn steered

business to Morgan Stanley's funds. In August 2012, Peterson was sentenced to nine months in prison.

(a) *Note*: The DOJ and SEC declined to pursue charges against Morgan Stanley, citing the company's cooperation with the government and effective anti-bribery compliance program, which Peterson circumvented.

D. There is very little case law, so risks often have to be evaluated on the basis of the DOJ's and the SEC's one-sided, and often expansive, interpretations of the FCPA.

E. Hedge fund receivership litigation

1. Former hedge fund manager Francisco Illarramendi settled criminal and civil charges in the U.S. arising from his alleged misappropriation of investor funds to finance a $500 million Ponzi scheme. Illarramendi allegedly paid Juan S. Montes, a former pension fund manager for Venezuelan state-owned oil company Petróleos de Venezuela, S.A. ("PDVSA"), over $35 million in bribes to induce the PDVSA pension fund to engage in bond-swap transactions with Illarramendi's hedge funds (these transactions provided temporary liquidity to sustain the Ponzi scheme). John J. Carney, a court-appointed receiver for Michael Kenwood Group LLC and related hedge funds, has filed suit in federal district court against Montes, seeking the return of these allegedly illicit payments for the benefit of the Ponzi scheme victims.

IX. Ways to Mitigate FCPA Risk

A. Fund level

1. Commitment from senior management ("tone from the top" against corruption)

2. An effective code of conduct with written policies and procedures that are periodically updated (should address: GTE, hospitality, retention of and dealings with agents/third-party intermediaries, facilitation payments, political and charitable contributions).

3. Designation of an FCPA compliance officer with: (a) direct reporting to and oversight by senior management; (b) autonomy in decision-making; and (c) adequate resources.

4. A risk-based approach tailored to the organization's specific needs and challenges (each fund's compliance program should be commensurate with the nature and extent of its interaction with foreign government officials).

5. Training and certifications for all directors, officers, relevant employees, and, where appropriate, agents and business partners

6. Clear incentives (i.e., positive measures to drive complaint behavior and negative disciplinary measures to deter unethical/unlawful behavior)

7. Third-party due diligence

8. Confidential reporting and internal investigations

9. Continuous improvement via periodic testing and review

B. Portfolio investment level

1. Risk assessment (key factors include: extent of the company's interaction with foreign governments; use of agents/third-party intermediaries; operating in high-risk jurisdictions).

2. Review of target's FCPA/anti-bribery compliance program (if it has one).

3. Examination of agent/consultant relationships (vetting third-party intermediaries via due diligence, approval requirements, documentation).

4. Background checks on principals

5. Questions regarding any FCPA/anti-bribery issues, investigations, etc.

6. FCPA contractual representations and warranties by third-party intermediaries

   (a) Full compliance (no materiality threshold)

   (b) No financial interest on part of government official

   (c) Termination rights

C. Ongoing FCPA compliance for portfolio companies

1. Establish compliance program if one doesn't exist.

2. Ensure that the program has elements appropriate for the nature of business (e.g., written policies and procedures, FCPA compliance officer, training of employees, employee certifications, due diligence on third-party intermediaries, periodic testing).

D. FCPA opinion procedure

1. Can request DOJ opinion as to whether certain prospective conduct, such as proposed business ventures involving foreign officials, violates the FCPA.

2. DOJ reviews and must issue an opinion within 30 days after a request is deemed complete.

3. Infrequently used, but the Guide recommends increased utilization of this avenue.

E. Corporate liability in the context of mergers and acquisitions

1. When a company merges with or acquires another company, the successor company assumes the liabilities of the predecessor company, including FCPA violations, regardless of whether it knows about them.

2. According to the Guide, the DOJ and SEC have only taken action against successor companies in limited circumstances — generally, in cases involving egregious and sustained violations or where the successor company directly participated in the violations or failed to stop the misconduct from continuing after the acquisition.

3. The government expects acquiring companies to conduct risk-based FCPA due diligence on prospective targets and to take appropriate steps if an actual or potential violation is identified in the course of due diligence.

4. According to the Guide, the DOJ and SEC encourage companies engaging in mergers and acquisitions to take the following actions and "will give meaningful credit to companies who undertake these actions, and, in appropriate circumstances, . . . may consequently decline to bring enforcement actions."

   (a) Conduct thorough risk-based FCPA and anti-corruption due diligence.

   (b) Ensure that the acquiring company's code of conduct and compliance policies/procedures apply as quickly as possible to newly acquired businesses or merged entities.

   (c) Train the directors, officers and employees of newly acquired businesses or merged entities and, when appropriate, train agents and business partners.

(d) Conduct an FCPA-specific audit of all newly acquired or merged businesses as quickly as practicable.

(e) Promptly disclose any corrupt payments that are discovered.

5. The DOJ has issued opinions under its opinion procedure regarding the liability of an acquirer for FCPA violations committed by a target.

   (a) Opinion Procedure Release 2003-01 (A U.S. Issuer [Acquirer] sought to purchase the stock of Company A, a U.S. company with domestic and foreign subsidiaries [Target]). During due diligence, Acquirer discovered payments made by Target to individuals employed by foreign state-owned entities. Both companies commenced parallel investigations of Target's activities around the world and disclosed the findings to the government. Pre-acquisition, Acquirer encouraged Target to undertake remedial measures and Acquirer promised DOJ it would implement numerous post-acquisition measures after becoming the owner of Target. DOJ stated that it did not intend to take any enforcement action against the Acquirer for the pre-acquisition conduct of the Target.

   (b) Opinion Procedure Release 2004-02 (An Investment Group [Acquirer] sought to acquire certain companies and assets from ABB Ltd. [Target] relating to its upstream oil, gas and petrochemical business). Prior to acquisition, Acquirer and Target agreed to conduct an extensive FCPA compliance review (involving a five-year look-back period, several forensic accountants, 115 lawyers billing over 44,700 man-hours, document review of millions of pages, 165 interviews of employees and agents, visits to 21 countries, 100 staff members, 22 analytical reports, and everything was shared with the government). DOJ stated that it did not intend to take any enforcement action against the Acquirer or the recently-acquired Target entities for pre-acquisition conduct.

   (c) Opinion Procedure Release 2008-02 (A U.S. Issuer, Halliburton Company [Acquirer] bid to acquire the entire share capital of an oil and gas services company that was based in the United Kingdom and traded on the London Stock Exchange [Target]). Because of particular restrictions in U.K. law regarding the bidding process for a public company, Acquirer had insufficient time and inadequate access to information to perform robust pre-acquisition due diligence. Thus, Acquirer sought an opinion from DOJ and submitted a detailed, post-closing plan with strict deadlines for post-acquisition due diligence and remediation related to Target. DOJ stated that it did not intend to take any enforcement action against the Acquirer for: (1) acquisition of the Target, reasoning that the funds contributed as part of this corporate combination transaction could not be considered a "payment" that is "in furtherance of" a bribe given that the Target was publicly listed on a major exchange with a majority of its shares held by large, institutional investors; (2) any pre-acquisition conduct by the Target disclosed to the DOJ during the 180-day period following the closing; and (3) any post-acquisition violations committed by the Target during the 180-day period after closing, provided that the Acquirer disclosed and remediated any illicit conduct.

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Current Tax Developments

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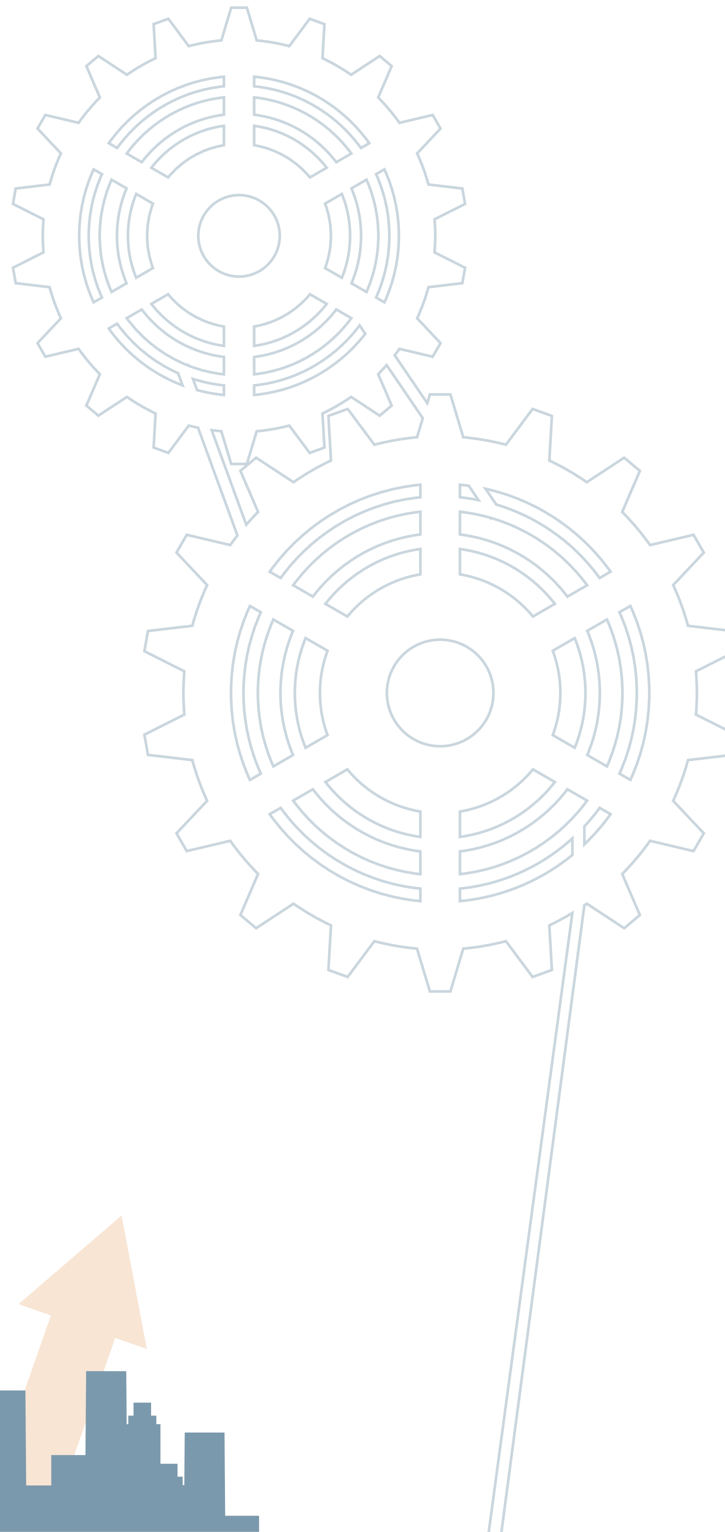

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Dominique is a member of the New York State Bar Association, the American Bar Association and the Integrated Bar of the Philippines. She is recognized by *The Legal 500 United States* and, in 2000, she received the prestigious AT&T Asia Pacific Leadership Award.

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Shlomo regularly speaks at industry conferences and events, and has addressed such topics as "FATCA and Dividend Equivalent Withholding Developments," "Tax Update 2012: FATCA and Other Issues" and "The Return of CLOs: Changes That Matter to Managers and Investors" for various SRZ seminars. He is a member of the Tax Section of the New York State Bar Association.

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Current Tax Developments[1]

I. Impact of New Medicare Tax on "Net Investment Income"

A. Previously, self-employment income and an employee's wages and bonuses were subject to Medicare tax at a rate of 2.9 percent. Currently, the limited partners of an investment manager can benefit from an exemption from this tax under Section 1402(a)(13) of the Internal Revenue Code (the "Code") with respect to their income allocations (but not their guaranteed payments). On Jan. 1, 2013, the "employer" piece increased to 2.35 percent for earned income over a specified amount, for a total tax of 3.8 percent. Employer and partner (self-employed individuals) deductions will remain available only for the first 1.45 percent.

B. On Jan. 1, 2013, an additional 3.8 percent unearned income Medicare contribution tax (the "Net Investment Income" tax) on investment income went into effect. Section 1411 of the Code imposes this tax on the "net investment income" (or the undistributed "net investment income," in the case of estates and trusts) of taxpayers whose adjusted gross income (with certain modifications) exceeds a threshold amount.

C. In November, the U.S. Treasury Department issued proposed regulations intended to be effective beginning in 2014, though taxpayers may rely on them for purposes of compliance with section 1411 of the Code prior to their effective date.[2] The proposed regulations provide definitions to key terms and additional clarifications on the types of entities and income to which the Net Investment Income tax applies.

D. Net investment income generally includes gross income from interest, dividends, annuities, royalties, and rents and net gain from dispositions of property, as well as trade or business income which is income from a "passive activity" with respect to the taxpayer.

1. Under the proposed regulations, an individual, estate, or trust that would be subject to the Net Investment Income tax can regroup its activities for purposes of determining passive activity under Section 469 of the Code. A taxpayer may only avail itself of the opportunity to regroup once.[3]

2. Controlled foreign corporation ("CFC") and passive foreign investment company ("PFIC") income are not directly addressed by Section 1411, but will be included in net investment income if the trade or business of the CFC or PFIC is a passive activity, or consists of trading in financial instruments or commodities.

E. The Net Investment Income tax would apply to incentive allocations or other carried interest allocated to investment management firms and investment returns for investors in funds. In contrast, fee income allocated to the limited partners who work for the investment manager could be excluded from the Net Investment Income tax if the limited partners are active service providers such that their investment in the fund is not a "passive activity" within the meaning of Section 469 of the Code.

F. Income thresholds and special rules

1. The threshold amount above which the Net Investment Income tax can apply is: $250,000, for taxpayers filing jointly (or as a surviving spouse); $125,000, for married taxpayers filing separately; and $200,000, for all other cases.

2. Net operating loss carryforwards do not reduce net investment income.

3. Self-employment income is not included in net investment income.

[1] As of Jan. 4, 2013.

[2] Preamble, REG-130507-11, Federal Register Vol. 77 No. 234, 72632.

[3] Prop. Reg. 1.469-11(b)(3)(iv).

4. The Net Investment Income tax does not apply to a nonresident alien, or a trust all of the unexpired interests in which are devoted to one or more charitable purposes.

II. FATCA and IGA

A. Foreign Account Tax Compliance Act ("FATCA")

1. FATCA mandates information reporting and withholding procedures to ensure that U.S. persons invested in foreign entities are reported to the U.S. Internal Revenue Service.

(a) In order to avoid being subject to withholding on certain U.S.-source payments, foreign financial institutions ("FFIs") must generally enter into agreements with the IRS. These agreements would require an FFI to implement due diligence and verification procedures for the identification of U.S. account holders, to report this information to the IRS and to withhold on payments to accounts that do not provide the necessary information (as well as certain FFIs that do not enter into or comply with such an agreement).

(b) U.S.-source income withholding begins in 2014, while U.S.-source gross proceeds withholding and pass-through payment withholding begins no earlier than 2017.

2. FATCA issues for private funds

(a) Covenant on FATCA compliance

(i) Uncertainty prevents an investment fund from providing a blanket covenant that the fund will avoid FATCA withholding taxes. To the extent that a fund must provide some covenant, the fund should qualify the covenant with the obligation to make "commercially reasonable efforts" or "reasonable efforts."

(ii) With or without a FATCA compliance covenant, funds will want to require investors to cooperate with the information and reporting requirements of FATCA, agree to take reasonable actions necessary for the fund to satisfy its FATCA obligations and acknowledge that the fund may take any necessary steps to comply with FATCA and avoid withholding.

(b) Manager compensation

(i) FATCA withholding has the potential to decrease fund assets generally or net asset value ("NAV") relating to a specific investor. In either case, manager compensation could be adversely affected if not properly calculated.

(ii) Calculation of management fees and incentive fees or allocations should be based on fund assets or NAV that do not take into account any value reduction associated with FATCA taxes when such taxes are due to investor non-cooperation.

(iii) A mechanism by which any FATCA tax imposed on the fund because of an investor's non-cooperation is explicitly charged to such investor should be incorporated in the fund documents.

(c) Funds should ensure they are prepared for the FATCA withholding regime to go into effect, including updating subscription documents and organizational documents, and appointing FATCA compliance personnel.

B. The FATCA IGA Model II

1. Over the course of 2012, the IRS and the Treasury Department began to negotiate intergovernmental agreements ("IGAs") with other countries. These IGAs are

intended to facilitate compliance and reduce costs by allowing an FFI to comply with its local jurisdiction's IGA instead of the general FATCA rules.

2. On Nov. 15, 2012 the IRS published the Model II Intergovernmental Agreement as a template for the information-sharing agreements it intends to enter into with foreign jurisdictions ("FATCA partners") to implement FATCA. Switzerland and Japan are expected to be the initial counterparties to enter into such Model II agreement.

3. The Model II IGA provides for FFIs to report directly to the IRS, as under the proposed FATCA regulations. By contrast, the earlier Model I IGA required FFIs to report to their local tax authorities, who would then exchange the information with the IRS. The U.K., for example, has entered into a Model I agreement.

4. Notable provisions of the Model II IGA

   (a) The IGA provides that an otherwise-compliant FFI may not have to comply with the strict withholding requirements of FATCA. Withholding on recalcitrant account holders is suspended if:

      (i) The FFI complies with the IGA; and

      (ii) The FATCA partner tax authority exchanges the requested information with the IRS within six months of a request for information.

   (b) However, the Model II IGA keeps intact the requirement on FFIs to impose "gross proceeds" or "foreign passthrough payment" withholding on payments made to nonparticipating FFIs after Jan. 1, 2017.

   (c) Annex II of the Model II IGA provides a list (and definitions) of entities exempt from some or all of FATCA's requirements. Examples include small financial institutions with local client bases, and group reporting allowed in the context of collective investment vehicles.

      (i) The IRS and the Treasury Department intend for Annex II to be negotiated and tailored specifically for each FATCA partner that enters into a Model II IGA.

   (d) The Model II IGA defines a "U.S. Account" as a financial account held by one or more "specified U.S. persons" or a non-U.S. entity with one or more controlling persons that is a specified U.S. person. The entity test is in contrast with the regulations issued under FATCA, which uses an ownership-percentage test instead of requiring control by a U.S. person.

   (e) Model II requires a FATCA partner FFI to condition entering into new obligations with nonparticipating FFIs that is expected to result in the payment of a foreign reportable amount on obtaining consent to information reporting.

   (f) The IGA contains a "most favored nation" clause that entitles the FATCA partner to any more favorable terms in the "benefits" article and due diligence annex that any other Model II-based IGA provides.

   (g) The Model II IGA excludes from the definition of "account holder" a non-financial institution that holds a financial account for the benefit of another (as agent, custodian, etc.).

   (h) The concept of "aggregate information" reporting on non-consenting, pre-existing account holders is included but undefined.

   (i) Model II due diligence: "certificate of residence" for documentary purposes may be issued by any authorized government official, not just a tax official (in contrast to the Model I IGA).

(j) FFIs with branches in other jurisdictions with laws that prevent compliance won't lose their compliant status just because of this.

III. U.K. Tax Issues

A. U.K. FATCA compliance implementation

1. U.K. HM Revenue & Customs ("HMRC") has issued draft regulations intended to implement the U.S./U.K. IGA and give it force under U.K. domestic law, together with draft guidance (for the use of both HMRC agents and taxpayers) on the practical implementation of the U.S./U.K. IGA. Both the draft regulations and the draft guidance have been issued for consultation and comment (with the consultation period closing on Feb. 13, 2012).

2. Application of FATCA reporting to U.K. entities

(a) It appears that U.K. FFIs will still have to register with the IRS, though the details of the registration process have not been finalized and published yet. However, all reporting will go to HMRC (which will provide the reported information to the IRS under the terms of the U.S./U.K. IGA).

(b) Several classes of entities are exempt from compliance with the reporting provisions of the IGA or have reduced compliance duties, including:

(i) Retirement funds;

(ii) Entities whose beneficial owners are exempt;

(iii) Deemed-compliant entities, including non-profits, and financial institutions with local client bases; and

(iv) Any entity that would be exempt under U.S. law. (As a general matter, the draft guidance clarifies that the intention is that the U.K. regulations should narrow and not widen the scope of a U.K. reporting entity's obligations, and hence a U.K. entity will be entitled to rely upon a more generous interpretation of its obligations under U.S. FATCA rules, even where the regulations might impose more onerous duties.)

(c) Those entities which are U.K. reporting FFIs include many kinds of "investment entity" (which is defined to include collective investment schemes, investment managers, distributors and administrators, etc.). This creates the scope for multiple reporting by different entities and might also imply that a U.K. investment manager to a collective investment scheme, for example, was required to report to HMRC in respect of financial accounts in the U.K. investment manager itself. However, the draft guidance seeks to clarify that where a U.K. entity is an "investment entity" (and hence technically a U.K. reporting FFI) solely by virtue of its relationship to a collective investment scheme (as defined in relevant U.K. legislation), only the collective investment scheme will be treated as a reporting entity (to the extent that it is subject to U.K. reporting jurisdiction) and no other entity providing services to that collective investment scheme will be treated as an "investment entity" liable to report to HMRC (either in respect of itself or the collective investment scheme).

(d) The U.K. IGA only applies to U.K. tax resident entities or to U.K. "permanent establishments" of FFIs. Where a U.K. investment manager (or other service provider) provides services to a fund in another jurisdiction, the U.K. investment manager will have no reporting obligations in respect to the fund, and instead the fund will be subject to its own reporting obligations according to the relevant rules for its jurisdiction of tax residence, i.e., reporting to its own tax authority where the fund is resident in a "Partner Jurisdiction" that has entered into its own Model I IGA with the U.S, or direct reporting to the IRS in cases where the fund is resident in a jurisdiction that is not a "Partner Jurisdiction." (The investment manager may of course, as a contractual matter between the fund and the investment manager, assume reporting duties on behalf of the fund to the appropriate authority, but the primary obligation will remain that of the fund itself.)

(e) Certain products and accounts are exempt from reporting requirements under the draft regulations:

(i) Certain retirement and pension accounts;

(ii) Individual savings accounts;

(iii) Tax-exempt saving plans; and

(iv) Certain employee stock compensation plans.

(f) Guidance is still pending on several categories of account, including dormant and undesignated accounts, and accounts of deceased persons.

(g) The guidance provides examples of and additional information regarding the procedures by which an account holder can self-certify as non-U.S., and an FFI can verify the certification provided.

B. U.K. compensation and deferral requirements

1. U.K. investment managers have been largely exempt from onerous obligations (e.g., to defer a part of their compensation for a period subject to forfeiture and pay a part of their compensation in the form of shares or share-like instruments) under the FSA Remuneration Code. This was as a result of the application of the EU "proportionality principle" which permitted the rules applicable to financial institutions generally to be applied on a proportionate basis.

2. However, U.K. investment managers will also become subject to the remuneration provisions of the Alternative Investment Fund Managers Directive, which impose similar remuneration obligations to those contained in the FSA Remuneration Code. Detailed European legislation is awaited, but it is presently unclear to what extent the "proportionality principle" can continue to be applied to exempt investment managers from the full reach of the AIFMD remuneration rules (given the application of those rules to investment managers only, instead of financial institutions generally, there would seem to be less scope to disapply the rules to investment managers as a category through a proportional application of the rules to different groups).

3. The application of rules requiring part of an individual's remuneration to be deferred for a substantial period and made subject to forfeiture is also potentially difficult because the majority of U.K. investment manager entities are established as partnerships, where individual partners are subject to tax on their allocations of profit from the entity, irrespective of their non-receipt of those profit allocations. In some scenarios, this might mean that an individual partner in a U.K. investment manager constituted as a partnership might be liable to pay an amount of tax on an allocation of profit from the partnership that is greater than the amount of his actual cash receipt from the partnership.

4. As a result, a number of U.K. investment managers are currently exploring management company structures that might facilitate compliance with the anticipated deferral/forfeiture of remuneration provisions of the AIFMD without that compliance having potentially punitive tax consequences. Typically these structures utilize a limited company which becomes a partner in the U.K. management company partnership and receives an allocation of those part of the profits which are intended to be subject to deferral/potential forfeiture and is subject to tax on those profits at U.K. corporation tax rates (which are generally lower than the rates of income tax applicable to individuals). There are then a number of methods of distributing these profits from the limited company to individual partners upon the vesting of the deferred entitlements.

IV. Hedge Fund Tax Audits

A. New York City unincorporated business tax audit position

1. Introduction

(a) New York City imposes a four percent tax on the income (net of certain expenses) of unincorporated businesses doing business in New York City (the "UBT").[4]

(b) Most alternative investment fund managers receive compensation in the form of a management fee and an incentive allocation (also referred to as carried interest). Most managers organize two separate vehicles to receive the two types of income. Typically, the general partner of the domestic fund (the "General Partner Entity") receives the incentive allocation and the investment manager vehicle (the "Investment Manager Entity") receives the management fee. Management fees are currently subject to the UBT, but the incentive allocation is not.[5]

(c) New York City, like most cities across the country, continues to face budget deficits and rising debt levels.[6] Given this economic climate, New York City is creatively searching for sources of additional revenue.

(d) In the last quarter of 2011, the New York City Department of Finance discussed the adoption of a new audit position that would increase an alternative investment fund manager's liability for the UBT.

(i) New York City calculates the UBT net of certain expenses. Under this new audit position, certain expenses previously deductible by the vehicle earning the management fee would be reallocated to the vehicle that receives the incentive allocation/carried interest. By reallocating these expenses, managers would be subject to the UBT on a larger portion of the management fee.

(ii) The Department of Finance has not issued any formal guidance on this new audit position.

(iii) By going after the allocation of expenses and not by attempting to tax the incentive allocation/carried interest directly, the Department of Finance is clearly trying to find new sources of revenue without having to enact new law.[7]

(iv) Many practitioners have found it troubling that the Department of Finance might apply this new audit position retroactively to all open tax years.[8]

2. Problems with the audit position

(a) The Department of Finance does not appear to have any authority under the UBT to take such a position.[9]

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[4] NYC Admin. Code Section 11-503.

[5] NYC Admin. Code Section 11-502(c).

[6] Jennifer Banzaca, "Proposed New York City Audit Position Can Increase the Amount of Unincorporated Business Tax Paid by New York Hedge Fund Managers, "Vol. 5 No. 2, *The Hedge Fund Law Report* (Jan. 12, 2012).

[7] Cara Griffith, "The Questionable Legality of New York City's Proposed UBT Audit Position," *Tax Notes* (Feb. 27, 2012).

[8] Jennifer Banzaca, "Proposed New York City Audit Position Can Increase the Amount of Unincorporated Business Tax Paid by New York Hedge Fund Managers," Vol. 5 No. 2, *The Hedge Fund Law Report* (Jan. 12, 2012).

[9] Amy Hamilton, "New York City Considers Changing Audit Position on Hedge Fund Managers," *Tax Analysts* 2012-2895 (citing PricewaterhouseCoopers for the proposition that the Department of Finance does not have any "section 482-type authority" regarding the UBT to justify the disallowance of these expense deductions); *See also,* NYC Admin. Code Section 11-605.5.

(i) The Department of Finance might assert general authority to reallocate items of income and deduction among related entities as permitted to the Service under Section 482 of the Code.[10] However, the Department of Finance does not have authority to apply Section 482 to the UBT. The NYC Administrative Code does not reference Section 482 or borrow language or terminology from Section 482.[11]

(b) The Department of Finance has not explained by what rationale it would choose to reallocate expenses or what types of expenses they would claim are more properly allocated to the General Partner Entity.

(i) Some speculate that the Department of Finance would reallocate the salaries paid by the Investment Manager Entity to the General Partner Entity.[12]

(ii) Others assume that the Department of Finance would reallocate a portion of all investment management expenses.[13] The portion allocated away from the Investment Manager Entity to the General Partner Entity might be calculated by the percentage incomes of each entity. This typically would allocate a much larger proportion of manager expenses to the General Partner Entity, given that income from the incentive allocation usually significantly exceeds management fee income.[14]

(iii) As a possible defense to an audit on these grounds, some have suggested documenting fund expenses attributable to each of the entities and providing detailed reasoning as to why such expenses are allocable to that entity.[15] This would make it more difficult for the Department of Finance to legally justify any reallocations.

3. Suspension of the audit position

(a) The Department of Finance has suspended its audit position regarding reallocating expenses for the UBT.[16]

V. Update on Carried Interest

A. In recent years, various proposals have arisen to change the taxation of the investment manager's carried interest in fund profits. Increasing carried interest taxation has been discussed as a potential source of revenue to mitigate the national deficit or fund entitlement programs, and has been somewhat politicized as an issue.

B. The current state of carried interest taxation

1. The investment manager is not taxed on the initial receipt of its carried interest, unless the interest is disposed of within two years or is a limited partnership interest in a publicly-traded partnership.[17]

2. The investment manager's carry is an allocation of income from a partnership (or an entity electing to be taxed as a partnership under the check-the-box regulations

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[10] 26 USC Section 482.

[11] Cara Griffith, "The Questionable Legality of New York City's Proposed UBT Audit Position," *Tax Notes* (Feb. 27, 2012).

[12] Jennifer Banzaca, "Proposed New York City Audit Position Can Increase the Amount of Unincorporated Business Tax Paid by New York Hedge Fund Managers," Vol. 5 No. 2, *The Hedge Fund Law Report* (Jan. 12, 2012).

[13] *Id.*

[14] *Id.*

[15] *Id.*

[16] Amy Hamilton, "NYC Suspends Audit Position on Private Investment Funds," *State Tax Notes* (Sept. 17, 2012) (citing the Department of Finance press secretary, "we are not pursuing an audit program specific to the hedge fund industry at this time").

[17] Rev. Proc. 93-27, 1993-2 C.B. 343.

under section 7701 of the Code). Income items of a pass-through entity retain their character when allocated to a partner, and so the investment manager's carry will have the initial character of the income when earned by the fund. To the extent that this income qualifies for the preferential capital gains rate, the investment manager will also be able to take advantage of the rate.

C. Proposals for reform

1. During the 2012 U.S. presidential election, the investment management industry came under scrutiny, including the taxation of managers as a potential source of disparity or unfairness in the tax code.[18] Some, generally Democrats, called for tax reform, usually in the form of re-characterizing carried interest income as ordinary income.

2. The election brought publicity to an issue that has been increasingly pursued by some members of Congress. On Feb. 14, 2012, the Carried Interest Fairness Act of 2012 was introduced in the House of Representatives. The bill is specifically aimed at "fix[ing] the carried interest loophole."[19] The Act's proposals include:

   (a) Taxing receipt of partnership interests transferred in connection with the performance of services;

   (b) Treating the investment manager's carry as ordinary income, rather than allowing it to retain its character at the partnership level; and

   (c) Increasing penalties for failure to report carried interest income as ordinary income.

3. The Carried Interest Fairness Act has been referred to committee, and has yet to be acted upon by either house of Congress. Even if the Act does not pass, it is possible that the specific changes outlined in the bill could be part of a broader tax reform package.

4. On Jan. 2, 2013, President Obama signed the American Taxpayer Relief Act into law. This legislation, which makes permanent many of the temporary tax rate reductions implemented in 2001, does not directly change carried interest taxation, though it does increase the capital gains rate from 15 percent to 20 percent on taxpayers with income above $400,000 (for individuals) or $450,000 (for joint filers).[20]

[18] Dylan Matthews, "What is the carried interest loophole, and why doesn't Romney want to close it?" *Washington Post*, Aug. 15, 2012.

[19] Rep. Sander Levin press release, "Carried Interest Fairness Act of 2012." http://levin.house.gov/press-release/carried-interest-fairness-act-2012.

[20] Kevin Mahn, "Fiscal Cliff Deal: Four Tax Provisions Handled, One Hiked, Still Work To Be Done." *Forbes*, Jan. 3, 2012.

Schulte Roth & Zabel

CFTC Regulatory Update

Speakers

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David Efron
Jacob Preiserowicz
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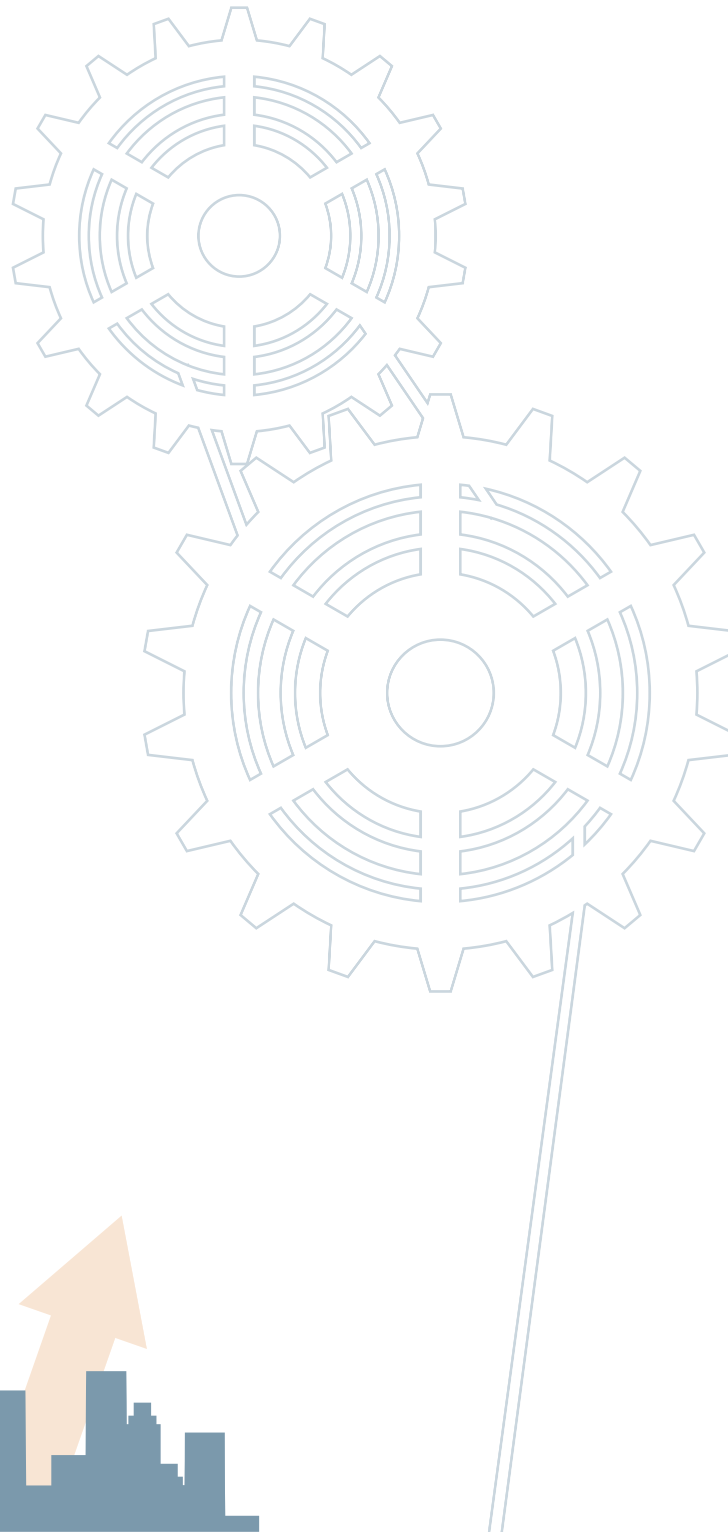

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Brian focuses on advising hedge and private equity fund managers on regulatory, compliance and operational matters, including registration and disclosure obligations, trading issues, advertising and marketing and the establishment of compliance programs.

Having spent nearly a decade serving in-house as general counsel and chief compliance officer at several prominent hedge fund firms, Brian is well-versed in a wide range of legal and business challenges facing investment advisers and other financial services entities and has represented clients in proceedings and interactions with regulators in the U.S., the U.K. and Asia. He also has extensive experience interfacing with internal and external resources to design and improve processes and organizational systems.

Brian is well-known for his thought leadership in the regulatory and compliance area as it affects alternative investment funds, and he recently co-authored "FSA Conflicts of Interest Safeguards: Action To Be Taken by All UK-Authorised Hedge Fund Managers" for *The Hedge Fund Journal*. Brian has also served as co-chair of the Managed Funds Association's General Counsel Forum and as a steering committee member of its Investment Advisory Committee. He is a visiting lecturer at Yale Law School, where he teaches a class on legal ethics, and frequently speaks on industry panels and at educational outreach events.

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

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David practices in the areas of domestic and offshore hedge funds, including fund formations and restructurings. Additionally, he advises hedge fund managers on structure, compensation and various other matters relating to their management companies, and structures seed capital and joint venture arrangements. David also represents hedge fund managers in connection with SEC regulatory issues and compliance-related matters.

David is listed in *Who's Who Legal: The International Who's Who of Private Funds Lawyers* and 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."

A published author on subjects relating to investment management, David also is a sought-after speaker for hedge fund industry conferences and seminars, and a frequent guest lecturer at New York-area law and business schools. Some of his recent presentations include "Navigating Institutional Investor Due Diligence and Best Practices for Hedge Funds" for the Hedge Fund Cares Seminar and "Potential Impact of the JOBS Act on the Hedge Fund Industry" for a Goldman Sachs webinar.

David received his LL.M. in securities regulation, with distinction, from Georgetown University Law Center, his J.D. from Syracuse University College of Law and his B.A. from Vassar College.

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Jacob focuses his practice on counseling commodity pool operators, commodity trading advisors, other commodity professionals and private investment fund managers on operational, regulatory and compliance matters. He regularly advises hedge funds, private equity funds and registered funds with respect to the U.S. Commodity Futures Trading Commission's exemptions, registration and reporting requirements and compliance with the requirements of the National Futures Association. Jacob conducts training sessions with respect to regulatory compliance matters, and helps guide firms through regulatory examinations. He also has expertise in the formation and ongoing operational needs of hedge funds and other private investment funds.

Jacob joined the firm from the CFTC, where he served most recently as Special Counsel in the Division of Swap Dealer and Intermediary Oversight. At the CFTC, he drafted new regulations and worked on a broad range of matters relating to CFTC registration and compliance. Recently, Jacob presented "CFTC Update: What Fund Managers Need to Know" for a Bank of America Merrill Lynch conference call.

Jacob earned both J.D. and M.B.A. degrees from Fordham University. He was the Notes & Articles Editor of the *Fordham Journal of Corporate & Financial Law* and received *cum laude* honors from the Fordham University Graduate School of Business. He received his B.A., *cum laude*, from Brooklyn College.

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Joseph focuses on corporate and securities matters related to investment funds and financial products. He primarily represents investment managers, financial services firms, private investment funds and charitable foundations and other institutional investors, advising his clients in connection with the structuring of, or investments in, private investment funds (including hedge funds and funds of hedge funds), structured finance vehicles (including CLOs) and financial products (such as structured notes, credit derivatives, equity derivatives, total return swaps, fund-linked derivatives and fund-linked notes).

Joseph, who speaks Portuguese and lived in Brazil for nine years, coordinates SRZ's Latin American client practice efforts, focusing primarily on the Brazilian investment management industry. His investment management clients include U.S. managers offering investment funds to Brazilian investors and Brazilian managers offering private investment funds to U.S. investors. He advises them in structuring the investment funds and in connection with all related U.S. corporate, securities and investment adviser regulatory issues.

Joseph is a member of the Banking & Capital Markets Committee and the Trade & Business Investment Committee of The Brazilian-American Chamber of Commerce, the Securities Regulation Committee of the New York State Bar Association and its Private Investment Fund Subcommittee, the Derivatives and Structured Products Law Committee of the New York State Bar Association, the Managed Funds Association Outside Counsel Forum and the Thomson Reuters Business Law Partner Advisory Board.

A frequent writer and speaker in his area of expertise, Joseph has published articles in *LatAm Fund Manager* and *Thomson Reuters Accelus*, among others. He moderated and spoke at the Brazilian-American Chamber of Commerce panel on "Challenges and Opportunities in Investing in Brazilian Infrastructure, Small and Mid-Cap Companies, High Yield Bonds and M&A" and spoke on "Raising Capital in the USA" at DMS Management's second annual *Offshore Investment Funds Summit* in São Paulo. Joseph is frequently quoted by newspapers, trade publications and journals, including *American Banker*, *Total Securitization* and the Fox Business Network, on a wide variety of issues in the investment and structured products industries.

Joseph obtained his J.D. from Fordham University School of Law, where he was associate editor of the *Fordham Law Review*, and his undergraduate degree from Cornell University.

CFTC Regulatory Update

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CFTC Regulatory Update

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CFTC Regulatory Update

I. CPO and CTA Registration

A. A "commodity pool" is an enterprise that is operated:

1. For the purpose of trading in CFTC-regulated instruments, including contracts for future delivery of a commodity, security futures products, certain swaps, certain commodity and futures options, certain "leverage transactions" and retail off-exchange forex contracts ("commodity interests").

2. Pools which invest in other commodity pools (e.g., funds of funds) are also considered pools operated "for the purpose of."

B. A "commodity pool operator" ("CPO") is, broadly described, an individual or an entity that:

1. Operates a commodity pool or similar enterprise; and

2. Solicits, accepts or receives funds or other property from others for the purpose of trading in commodity interests through that pool.

C. A "commodity trading advisor" ("CTA") is, broadly described, an individual or an entity that for compensation or profit, engages in the business of advising others as to the value of, or the advisability of, trading in commodity interests.

D. CPOs, CTAs and their "associated persons" must register with the Commodity Futures Trading Commission ("CFTC") unless they are excluded or exempted from registration.

1. Exemptions and exclusions from registration as a CPO are outlined in CFTC Regulations 4.5 and 4.13 and include the following:

(a) Persons otherwise regulated (e.g., banks, insurance companies, pension plans, registered investment companies) [Regulation 4.5].

(b) Operators of closely-held pools (i.e., where a person operates only one pool at any time, does not advertise in connection with the pool and does not receive any compensation) [Regulation 4.13(a)(1)].

(c) Operators of small pools (i.e., pools with less than $400,000 in aggregate capital contributions and no more than 15 participants although, notably, investments from principals of the CPO do not count toward this threshold, making this exemption an option for internal investment vehicles) [Regulation 4.13(a)(2)].

(d) Operators of pools with participation restricted to accredited investors, qualified eligible persons ("QEPs") (which include knowledgeable employees or non-U.S. persons) that also meet one of the following two de minimis tests: i.e., at the time a pool enters into a commodity interest transaction, either:

(i) the aggregate initial margin and premiums of the pool's positions do not exceed five percent of the liquidation value of the pool's portfolio; or

(ii) the aggregate net notional value of the pool's positions does not exceed 100 percent of the liquidation value of the pool's portfolio [Regulation 4.13(a)(3)].

(e) A widely utilized exemption for pools limited to QEPs [Regulation 4.13(a)(4)] was repealed last year. The effects of that action are discussed below.

2. Exemptions and exclusions from registration as a CTA are outlined in Section 4(m) of the Commodity Exchange Act ("CEA") and CFTC Regulation 4.14. Exemptions most commonly utilized by investment managers are where:

   (a) The CPO and CTA are the same entity and its commodity trading advice is directed solely to the pools for which it is registered or has claimed an exemption. [Regulation 4.14(a)(4)/4.14(a)(5)].

   (b) The CTA is a registered investment adviser whose business does not consist primarily of acting as, or holding itself out as, a CTA and that does not act as a CTA to any commodity pool that is engaged primarily in trading commodity interests. [Section 4m(3) of the CEA].

   (c) The CTA does not hold itself out generally to the public as a CTA and during the past 12 months it has not furnished commodity trading advice to more than 15 persons. (For purposes of this exemption, a fund is considered one person. Offshore CTAs need only count U.S. clients) [Regulation 4.14(a)(10); Section 4m(1) of the CEA].

   (d) The CTA is a registered investment adviser, advises Regulation 4.5 eligible entities, certain offshore commodity pools or Regulation 4.13(a)(3) pools, and the commodity interest trading advice is solely incidental to its securities or other investment advice [Regulation 4.14(a)(8)].

3. If a pool operator is qualified for an exemption from CPO registration (or a CTA for Regulation 4.14(a)(8)), it must electronically file a notice of exemption through the National Futures Association's ("NFA") electronic exemption filing system (with the exception of certain entities which qualify under Regulation 4.5).

   (a) Any persons filing for an exemption or exclusion from CPO registration under CFTC Regulation 4.5, 4.13(a)(1), 4.13(a)(2), 4.13(a)(3), 4.13(a)(5) or from CTA registration under CFTC Regulation 4.14(a)(8) (the other CTA exemptions are self-executing) must *annually* affirm the applicable notice of exemption or exclusion within 60 days of each calendar year-end.

   (b) Failure to affirm any of these exemptions or exclusions will be deemed a request to withdraw the exemption or exclusion and will result in the automatic withdrawal of the exemption or exclusion at the end of a 60-day period.

   (c) While CPOs who have recently claimed Regulation 4.13(a)(3) need not reaffirm those exemptions for 2012, *CPOs who have claimed other exemptions* (or have historically relied on Regulation 4.13(a)(3)) *or CTAs who have claimed Regulation 4.14(a)(8) should reaffirm the exemption* by March 2013.

E. CPO and CTA registration mechanics

1. Role of the NFA

   (a) The registration functions of the CFTC are performed by the NFA.

   (b) To satisfy CFTC registration obligations, CPOs and CTAs must also become NFA members and are subject to both CFTC and NFA rules (similarly, associated persons become associate members of the NFA).

2. Filing mechanics

   (a) Completed online Form 7-R (includes NFA membership sections).

   (b) Completed online Form 8-R applications for all principals and associated persons: principals and associated persons must also submit fingerprint cards, and associated persons may have to satisfy proficiency requirements (e.g., passing a Series 3 examination).

(c) Payment of firm application fees, firm-level membership dues and principal and associated person application fees.

II. Repeal of the 4.13(a)(4) Exemption and a Renewed Focus on the "De Minimis" Exemption

A. On Feb. 9, 2012, the CFTC announced that the Regulation 4.13(a)(4) exemption, which was widely used by investment managers for their funds and other pools that traded futures contracts, was to be repealed as of Dec. 31, 2012.

B. In the wake of the Regulation 4.13(a)(4) repeal, many managers sought an alternate exemption for some or all of their commodity pool relationships. For many of these managers, the Regulation 4.13(a)(3) de minimis exemption is available.

1. The threshold calculation is directly influenced by the universe of included instruments. The guidance on certain instruments has been evolving, but there is some clarity on the following:

(a) Foreign exchange ("FX")

(i) FX spot transactions, FX forwards and FX swaps *are not counted* for purposes of the de minimis test and also will not be subject to any CFTC-imposed central clearing, exchange trading and margin requirements.

(1) The CFTC rules define an FX forward as "a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange."

(2) An FX swap is defined as "a transaction that solely involves — (A) an exchange of two different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and (B) a reverse exchange of the two currencies described in subparagraph (A) at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange."

(3) While FX forwards and FX swaps are technically not CFTC-regulated swaps, these instruments are still subject to certain swap reporting requirements and business conduct standards.

(ii) Conversely, many currency derivatives such as foreign currency options, non-deliverable forwards[1] and cross-currency swaps[2] *are counted* for purposes of the de minimis test (and likewise will be subject to other swaps requirements).

(b) Contracts for differences ("CFDs"): CFDs (i.e., an agreement to pay or receive amounts based on the difference in value of an underlying asset that is realized between the entry into the CFD and its termination) on single securities are generally considered securities-based swaps (which are swaps regulated by the SEC) and, therefore, are not counted for purposes of the de minimis thresholds. However, CFDs on single securities with currency exposure could still be characterized as a mixed swap (and required to be counted) depending on the nature of the currency component.

(c) ETFs, CDOs, CLOs, other securitization vehicles.

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[1] A non-deliverable forward is a cash-settled swap where one party pays to the other the product of the notional amount and the difference between the contracted rate (set on the trade date) and a rate that is typically equal to or close to the spot foreign exchange rate. The parties do not exchange the currencies involved and they typically cash-settle using a single currency. A non-deliverable forward is often used in situations where cross-border trading of the relevant foreign currency is prohibited or otherwise limited.

[2] A cross-currency swap is defined as "a swap in which the fixed legs or floating legs based on various interest rates are exchanged in different currencies."

(i) It is possible for Index ETFs to be considered swaps on single securities, in which case they would be considered securities-based swaps and, therefore, not counted for purposes of the de minimis threshold.

(ii) CLOs, CDOs, other securitization vehicles: based on recent no-action relief, neither: (1) investments in securitization vehicles which use swaps only for hedging purposes; nor (2) investments in vehicles which do use swaps for other purposes, but are "legacy vehicles" that have not issued securities since Oct. 12, 2012, count for purposes of the de minimis test (Operators of such vehicles have also received no-action relief from themselves being required to register as CPOs).

2. Other mechanics of the de minimis exemption

(a) The calculation is to be performed at each time a pool enters into a transaction. Therefore, a pool would not be in violation of the thresholds if, for example, a decline in the pool's net asset value, and not a transaction, causes the pool no longer to satisfy either of the thresholds (but the pool would be in violation if it enters into another trade without coming back into compliance with the exemption).

(b) For the "net notional" test, netting is only allowed in certain limited circumstances, although it is possible the CFTC may take a more lenient approach in the future.

(c) Future reliance on the "margin" test may become more difficult as current proposed rulemaking anticipates requiring certain minimum levels of initial margin, even for uncleared swaps.

III. CFTC and NFA Compliance for Registered CPOs

A. Ethics training

1. Ongoing ethics training is a required component of CFTC registration. While in the past the CFTC had specific ethics training requirements, it has recently moved to a more flexible system, allowing firms to determine the format, frequency and provider of their training program.

(a) The NFA has indicated that firms should have written procedures that outline the ethics training program; this ideally will include information regarding the topics included, the provider, format and frequency, and procedures for documenting compliance with such written procedures.

(b) Firms will be expected to demonstrate why the program implemented (including its frequency and content) is appropriate for the firm.

2. An acceptable ethics training program would apply to all of a firm's associated persons and would require them to take their first training within six months of becoming registered.

(a) Training should be tailored based on the firm's business and operations, although there will obviously be certain principles and issues common to all registrants.

(b) General subjects that should be included include reviews and discussions of applicable laws and regulations, obligations to clients, establishing and implementing effective supervisory systems and internal controls, disclosure of material information to clients, and the avoidance, proper disclosure and handling of conflicts of interest.

3. There are no specific requirements regarding appropriate providers of training; in-house training programs are acceptable, as is the engagement of third parties

(although firms should verify that a third-party provider has three years of relevant experience and satisfies the NFA's proficiency requirements).

B. Bylaw 1101

1. Requirements of Bylaw 1101

(a) NFA Bylaw 1101 prohibits registered CPOs and CTAs (in their capacity as NFA members) from doing business with non-NFA members that are required to be registered with the NFA.

(b) Specifically, it prohibits an NFA member "from carrying an account, accepting an order or handling a transaction in commodity futures contracts for, or on behalf of," any non-member of the NFA required to be registered with the CFTC.

(c) NFA practice is to read Bylaw 1101 broadly.

2. NFA application of Bylaw 1101

(a) In applying Bylaw 1101, the NFA imposes a strict liability standard on any NFA member conducting customer business with a non-member that is required to be registered, although, to date, the NFA has generally only focused on situations where evidence indicates that the member knew or should have known of the violation.

(b) The NFA interprets Bylaw 1101 to require CFTC registrants, particularly CPOs, to confirm that:

(i) Business partners and other service providers are NFA members or are not required to be NFA members (i.e., are not required to be registered with the CFTC).

(1) NFA members should document that their business partners (e.g., futures brokers, introducing brokers and custodians) are appropriately registered or are otherwise exempt from CFTC registration; and

(2) Similarly, NFA members should give consideration to how this obligation applies to swaps activities.

(ii) Investors (particularly entity investors) in funds or other pools managed by a registered CPO are NFA members or are not required to be NFA members (i.e., are not required to be registered with the CFTC).

(1) This investor confirmation requirement is imposed on an entity as a result of it acquiring NFA membership; therefore, this obligation could be interpreted to extend to funds or other pools for which the registered CPO has claimed the Regulation 4.13(a)(3) de minimis exemption (because claiming the exemption for specific pools does not change the fact that the CPO is still an NFA member and subject to NFA requirements); and

(2) For investors, the NFA would generally expect members to ask investors to confirm their CFTC registration and NFA membership status; however (depending on the nature of the response received), it would also expect members to confirm the responses by checking the database of CFTC registrants and exemptions claimed on its website.

3. The NFA has also recently implemented the requirement for CPOs and CTAs to reaffirm the exemptions claimed on an annual basis, no later than 60 days after year-end.

(a) Therefore, it may be difficult to reconfirm investor status during the first quarter of 2013, as the NFA database has limited usefulness until the exemption claims have been reaffirmed.

(b) As a result, the NFA announced that any member that conducts business with a previously exempt person will not be in violation of Bylaw 1101 if they take "reasonable steps" to determine the registration and membership status of the persons between Jan. 1, 2013 and March 31, 2013.

(c) Although this could indicate that the NFA would not expect members to confirm the status of investors and business providers until March 2013, the NFA still requires reasonable steps to be taken in the interim, ostensibly meaning the NFA still expects members to reach out to persons it does business with to ascertain their NFA status.

(i) Generally, CFTC registrants can satisfy this requirement by including an NFA Bylaw 1101 questionnaire within subscription documents.

(ii) However, while new CFTC registrants can obtain such information from new investors going forward, most new registrants have not obtained that information from existing investors.

(iii) Therefore, given the NFA's requirement to take "reasonable steps," we recommend that new registrants immediately reach out to existing investors.

(d) While the NFA has generally recommended reconfirming investor status on an annual basis, it remains to be seen whether the NFA will instead allow members to rely on the NFA website (for investors who have stated they have claimed an exemption), considering that registrants now must actively reconfirm on an annual basis.

C. CPO-PQR and CTA-PR reports

1. The CFTC finalized rules on Feb. 24. 2012 that require registered CPOs to file Form CPO-PQR. The CFTC rules provide that the frequency of reporting and the amount of information to be included in each report vary in accordance with the CPO's assets under management, although CPOs that are filing Form PF with the SEC are not required to fill out most of Form CPO-PQR. Separately, since 2010, the NFA has its own PQR (pool quarterly reports), pursuant to NFA Rule 2-46. Rule 2-46 requires CPOs to submit a Schedule of Investments (which, included positions that exceed 10 percent of NAV but now requires positions which exceed five percent of NAV) together with other information similar to Schedule A of the CPO-PQR. The NFA has merged the two requirements, i.e., Rule 2-46 with the CFTC CPO-PQR requirement, to require one filing for both requirements (although it is still in the process of formally finalizing this merger) as follows:

(a) CPOs with more than $1 billion of AUM must complete the entire form on a quarterly basis, within 60 days of the quarter end (Form PF filers will only be required to file Schedule A and a Schedule of Investments on a quarterly basis, within 60 days of quarter end and within 90 days of year-end);

(b) CPOs with between $150 million and $1 billion of AUM must complete Schedule A and a Schedule of Investments on a quarterly basis within 60 days of the quarter end and Schedule A and B to the Form on an annual basis within 90 days of year-end (Form PF filers will only be required to file Schedule A and a Schedule of Investments within 60 days of quarter end and within 90 days of year-end); and

(c) CPOs with less than $150 million of AUM must file Schedule A and a Schedule of Investments on a quarterly basis (PF filers included) within 60 days of quarter end and within 90 days of year end, respectively.

2. The CFTC requires CTAs to file Form CTA-PR on an annual basis, although the NFA, by proposing to add its own PR filing, will essentially be requiring this filing from all CTAs on a quarterly basis.

3. Most new registrants were only registered as of January 1. Those CPOs and CTAs have no requirements with respect to 2012 and the first filing requirement will be for the first quarter of 2013 (i.e., due by end of May 2013).

4. Given the little guidance provided for the forms, the CFTC is allowing “reasonable assumptions” to be made in filling out the forms. The CFTC is expected to release revised guidance at some point this year which is expected to provide additional clarity on issues such as AUM calculations, how to treat fund of funds investments, side by side structures, master feeder structures and SPVs.

D. Annual audited financials

1. Historically, registered CPOs relying on Regulation 4.7 were not required to provide audited annual financials to pool participants. However, in 2012, the CFTC changed that approach and CPOs are now required to provide audited financials to pool participants, even for pools relying on Regulation 4.7. The timing of the delivery requirements are as follows:

    (a) Audited financial statements are required to be delivered within 90 days of the pool’s fiscal year-end (which is 30 days sooner than the SEC’s requirements for its registered advisers);

    (b) CFTC extensions are available in certain instances, but (except as noted below) do not apply for multiple years; and

    (c) funds of funds are eligible for a permanent extension, which would allow distribution of audited financials within 180 days.

2. In addition to providing the financial statements to investors, a copy must be filed with the NFA.

3. It is also worth noting that subject to certain conditions, offshore pools are permitted to use International Financial Reporting Standards rather than GAAP.

E. NFA annual self-examination questionnaire

1. The NFA requires its members to complete an annual self-examination questionnaire, which differs from the SEC’s annual review requirement.

2. The NFA requires all members to review and complete the self-examination questionnaire on an annual basis in order to help members identify and correct any supervisory deficiencies. The examination consists of a general questionnaire that is applicable to all NFA members and individual sections applicable to each CPO and CTA.

3. The general section of the examination consists of questions such as confirming that all sections of the Form 7-R and Form 8-R are updated with respect to all individuals and branch offices, that all individuals acting in the capacity of an associated person are appropriately registered, that an appropriate compliance program is in place, and that appropriate policies are in place regarding promotional materials (*see* “Marketing materials” below).

4. The specific section regarding CPOs and CTAs primarily consists of questions regarding compliance with many of the Regulation 4.7 requirements (e.g., reports, filings, books and records, etc.). Upon completion of the review, appropriate supervisory personnel must sign an attestation that the self-examination has been completed and that current procedures are adequate to meet the CPO’s or CTA’s supervisory responsibilities.

5. These signed attestations do not need to be filed with the NFA, but should be readily available for the most recent two years and retained for the most recent five years.

F. Marketing materials

1. The NFA requires its members to adopt and enforce written procedures to adhere with NFA rules with respect to marketing materials. This includes adoption of policies which require the review and approval *in writing* of any marketing materials.

2. The NFA also has specific prohibitions and requirements with respect to the contents of marketing materials:

(a) Restricting the use of hypothetical or simulated trading results that could have been achieved through the use of a particular trading system and requiring that they be accompanied by a specific cautionary statement, displayed in capital letters, boldface type and 10 point (or larger) font in the immediate vicinity of the results;

(b) Prohibiting the mention of the possibility of profit unless the possibility of loss also is mentioned with equal prominence;

(c) Prohibiting any mention of past performance unless accompanied by the following statement in all capital letters, boldface type and 10 point (or larger) font: PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS;

(d) Prohibiting the use of any specified numerical past performance data unless such information can be demonstrated to be reasonably representative and consistent with the CFTC's rate-of-return rules; and

(e) Requiring that statements of opinion, whether in the form of recommendations or otherwise, be clearly identifiable as such and have a reasonable basis in fact.

IV. Obligations for All Fund Managers

A. Obligations related to registration exemptions

1. Pool operators relying on exemptions from registration as CPOs should design and implement surveillance systems designed to ensure that each pool is in compliance with the applicable exemption (particularly if the CPO is relying on the de minimis exemption).

2. Annual reaffirmation of exemptions under Regulation 4.13, 4.14 4.5 and 4.14(a)(8).

3. Retention of records: CPO records (i.e., records in connection with its activities as a CPO as well as records which can demonstrate eligibility and compliance with the exemption the CPO is relying upon) must be maintained for a period of five years.

B. Aggregation and position limits

1. CFTC rules currently[3] impose position limits for certain physical commodity futures contracts. These position limits are in addition to (although they are subsumed by) the various position limit obligations imposed by futures exchanges. Specific CFTC rules require the aggregation of certain accounts for purposes of determining compliance with these position limits. *The position limits and aggregation rules*

[3] The CFTC had implemented more restrictive position limits which would have extended position limits to additional commodities and economically equivalent swaps and would have made it more difficult to obtain an exemption from aggregation. However, those rules were challenged and overturned by the U.S. District Court for the District of Columbia. The CFTC is appealing the court's decision but, regardless of the outcome of its appeal, the CFTC is expected to pursue reinstating some or all of those requirements.

apply to all persons who trade in futures, irrespective of registration status. The following are certain situations where aggregation is required:

(a) Any person who directly or indirectly holds positions or controls trading or positions held by two or more persons acting pursuant to an expressed or implied agreement or understanding the same as if the positions were held by, or the trading of the position were done by, a single individual;

(b) If investing in another pool which is relying on a Regulation 4.13 exemption, if ownership or equity interest in the pool is 25 percent or greater, the investor must aggregate the positions of that pool with its own positions for position limits purposes, even if there is no real-time knowledge of the trades (however, if the pool is relying on Regulation 4.7, there is no need to aggregate on the basis of 25 percent or more ownership);

(c) A CPO to a pool must also aggregate the positions of the pool with its other positions if it is a 10 percent or greater limited partner; and

(d) Similarly, a principal of a CPO must aggregate the positions of the pool if it also is a 10 percent or greater limited partner of the pool (although aggregation would not be necessary if certain policies and procedures are implemented).

2. However, there are also certain exemptions from aggregation.

(a) For example, in certain situations, an independent account controller exemption can be put in place which would provide relief from aggregation.

(b) While the independent account controller exemption is self-executing with the CFTC, certain boards of trade may require preapproval before using such an exemption.

(c) Similarly, the CFTC had required filings for exemptions in the recently overturned rule.

3. Firms implementing policies to comply with the position limits and aggregation rules today should be mindful that these requirements are likely to get more restrictive.

C. Central clearing

1. Overview: in September 2009, G-20 leaders agreed that: (i) all standardized OTC derivatives contracts should be traded on exchanges or electronic trading platforms, and cleared through central counterparties, by end of 2012; and (ii) non-centrally cleared contracts should be subject to higher capital requirements. In the U.S., the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 requires the U.S. regulators, among other things, to impose clearing requirements. The CFTC has been more aggressive than other regulators in proposing and implementing rules under the Dodd-Frank Act.

(a) On July 24, 2012, the CFTC issued final rules providing for phased compliance with CFTC-issued clearing mandates. Going forward, swap counterparties will be subject to mandatory clearing within 90, 180 or 270 days after the CFTC issues clearing mandates for specific contracts. Compliance dates vary by type of swap counterparty.

(i) “Category 1 Entities” are subject to mandatory clearing for a specific contract 90 days after the a clearing mandate is published in the Federal Register for that contract. “Active Funds” (i.e., funds that execute 200 or more swaps per month based on an average over the 12 months preceding the CFTC’s issuance of the clearing mandate) are Category 1 Entities (as are swap dealers and major swap participants).

(ii) All other funds are treated as "Category 2 Entities." Category 2 Entities are subject to the central clearing obligation 180 days after the applicable clearing mandate is published in the Federal Register.

(iii) All other entities (for example, third-party subaccounts or nonfinancial end users that are not eligible for or do not elect the end-user exemption) are "Category 3 Entities" and will need to start clearing 270 days after the applicable clearing mandate is published in the Federal Register.

(b) Counterparties to a swap transaction defer to the counterparty with the later compliance date.

2. Current Requirements: certain interest rate swaps and credit default swaps to be cleared in 2013.

(a) The Dodd-Frank Act requires the CFTC and the SEC to determine which OTC derivatives are subject to a clearing obligation.

(b) On Dec. 13, 2012, the CFTC finalized its first clearing mandate for swaps under the Dodd-Frank Act. The clearing mandate addresses certain credit default swaps and interest rate swaps that are currently being cleared by derivative clearing organizations. Such swaps entered into after the compliance date (March 11, 2013, June 10, 2013 and Sept. 9, 2013, for Category 1, 2 and 3 Entities, respectively) will be required to be cleared.

(i) The CFTC mandated clearing of four classes of interest rate swaps and two classes of index credit default swaps. Swaps that meet the basic specifications provided under the rules will be required to be cleared. Swaps that do not meet those specifications would be outside of the scope of this clearing mandate but swaps designed in a manner intended to take them outside the scope of a clearing mandate with no legitimate business purpose may be unlawful.

(1) These four classes of interest rate swaps include:

a. Certain fixed-to-floating swaps;

b. Certain basis swaps;

c. Certain forward rate agreements; and

d. Certain overnight index swaps.

(2) The two classes of credit default swaps include:

a. Certain credit default swaps in North American Untranched CDS indices; and

b. Certain credit default swaps in European Untranched CDS indices.

D. Business conduct standards for swaps

1. In early 2012, the CFTC finalized a Business Conduct Rule under the Dodd-Frank Act that imposes several business conduct standard requirements for swap dealers and major swap participants in their dealings with counterparties (i.e., funds). The CFTC has issued an interim rule to extend the compliance date for these rules until May 1, 2013.

2. One provision of the Business Conduct Rule requires that a swap dealer, whenever it recommends a swap or trading strategy to a non-swap entity,[4] undertake

[4] The term "swap entity" refers to swap dealers, security-based swap dealers, major swap participants and major security-based swap participants.

"reasonable diligence" to understand the potential risks and rewards of the swap and have a reasonable basis to believe the recommendation is suitable for the counterparty based on the counterparty's investment profile, trading objectives and ability to absorb potential losses.

3. Although the Business Conduct Rule does not specify what a swap dealer must do to establish that it has undertaken such reasonable diligence, it does provide the swap dealer a safe harbor with respect to its obligations to establish that a recommendation is suitable to a counterparty. To take advantage of the safe harbor, the swap dealer must meet the following requirements:

   (a) The swap dealer must reasonably determine that the counterparty, or an agent to which the counterparty has delegated decision-making authority, is capable of independently evaluating investment risks with regard to the relevant swap or trading strategy involving a swap. This requirement will be satisfied if the swap dealer receives written representations that:

      (i) In the case of a counterparty that is not a Special Entity,[5] the counterparty has complied in good faith with written policies and procedures that are reasonably designed to ensure that the persons responsible for evaluating the recommendation and making trading decisions on behalf of the counterparty are capable of doing so; or

      (ii) In the case of a counterparty that is a Special Entity, satisfy the terms of the safe harbor in Regulation 23.450(d)("Requirements for swap dealers and major swap participants acting as counterparties to Special Entities").

   (b) The counterparty or its agent must represent in writing that it is exercising independent judgment in evaluating the recommendations of the swap dealer with regard to the relevant swap or trading strategy involving a swap.

   (c) The swap dealer must disclose in writing that it is acting in its capacity as a counterparty and is not undertaking to assess the suitability of the swap or trading strategy involving a swap for the counterparty.

   (d) In the case of a counterparty that is a Special Entity, the swap dealer complies with the provisions under Regulation 23.440 ("Requirements for swap dealers acting as advisors to Special Entities") where the recommendation would cause the swap dealer to act as an advisor to a Special Entity.

   (e) Swap dealers may fulfill the requirements of the safe harbor provisions through representations and covenants either in a bilateral agreement (i.e., through an amendment of your ISDA schedule) or through the entry into the August 2012 ISDA Dodd-Frank Protocol ("DF Protocol").

   (f) Counterparties making these representations and covenants will need to consider whether they need to adopt specific policies that evidence a process for reviewing the suitability of swaps. Counterparties that are unwilling or unable to make these representations and covenants may find that swap dealers will be less willing to enter into trades with them or charge higher prices on transactions.

4. Funds are encouraged to enter into the DF Protocol or other bilateral agreement by May 1, 2013 so as to avoid disruption in their trading after that date.

[5] The term "Special Entity" means: (1) a Federal agency; (2) a state, state agency, city, county, municipality, other political subdivision of a state or any instrumentality, department or a corporation of, or established by, a state or political subdivision of a state; (3) any employee benefit plan subject to Title I of the Employee Retirement Income Security Act of 1974; (4) any governmental plan, as defined in Section 3 of the Employee Retirement Income Security Act of 1974; (5) any endowment, including an endowment that is an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986; or (6) any employee benefit plan defined in Section 3 of the Employee Retirement Income Security Act of 1974, not otherwise defined as a Special Entity, that elects to be a Special Entity by notifying a swap dealer or major swap participant of its election prior to entering into a swap with the particular swap dealer or major swap participant.

V. Other Developments for Operators of Certain Funds

A. Funds of funds: given the difficulties that managers of funds of funds faced under the CFTC's prior guidance on the applicability of the Regulation 4.13(a)(3) de minimis exemption, on Nov. 29, 2012, the CFTC provided no action relief which provides a registration exemption for funds of funds managers (who generally previously relied on the Regulation 4.13(a)(4) exemption) until the end of the six-month period following the issuance of written guidance on this topic by the CFTC.

B. Securitization vehicles: following the issuance of a Dec. 7, 2012 no-action letter, operators of certain securitization vehicles will not have to register (or may claim an exemption from registering) as a CPO if the securitization vehicle: (1) meets the criteria of Regulation AB; (2) only uses swaps for hedging; or (3) is a "legacy" vehicle that has not issued any securities since Oct. 12, 2012. Other types of vehicles have been provided relief that effectively delays the registration obligations of their operators through March 31. (As discussed above, similar relief has been provided to investors in vehicles which fit in the 3 categories).

C. REITS and business development companies: operators of certain REITs and business development companies have also been provided relief from being required to register as CPOs.

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