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# Hedge Fund Report - Summary of Key Developments - Spring 2011

BY THE INVESTMENT MANAGEMENT, SECURITIES LITIGATION & TAX PRACTICES

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")[1] into law, almost two years after the collapse of Lehman Brothers, which marked the beginning of a period of extreme stress and volatility in the global capital markets. The Dodd-Frank Act is comprehensive and affects almost all participants in our financial services and banking industries, including banks, depository institutions, holding companies, mortgage lenders, insurance companies, industrial loan companies, broker-dealers, investment advisers, hedge funds and other private investment funds, consumers and numerous federal agencies. Since the Dodd-Frank Act was passed, the Securities and Exchange Commission (the "SEC") and various other agencies, including the Commodity Futures Trading Commission (the "CFTC"), the Federal Reserve Board (the "Federal Reserve"), and the Department of the Treasury, have been busy proposing rules to implement provisions of the Dodd-Frank Act. Meanwhile, private litigants and the SEC continue to sort through the aftermath of the financial disruption as evidenced by recent enforcement and private actions.

This Report provides an update since our last Hedge Fund Report in October 2010 and highlights recent developments, including the Dodd-Frank rulemaking, as well as recent civil and enforcement actions as they relate to the hedge fund industry. Paul Hastings attorneys are available to answer your questions on these and any other developments affecting hedge funds and their investors and advisers.

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## I. SECURITIES-RELATED LEGISLATION AND REGULATION

### *A. The Dodd-Frank Rulemaking*

In the wake of the unprecedented financial crisis that caused a significant downturn in the global economy in 2008 and 2009, President Obama on July 21, 2010 signed the Dodd-Frank Act into law, in the hope to "restore responsibility and accountability in our financial system to give Americans confidence that there is a system in place that works for and protects them." Since then, various agencies have been focusing on the rulemaking process to implement provisions of the Dodd-Frank Act. Despite the issuance of numerous proposed rules, no final rules implementing the Dodd-Frank Act have been adopted as of the date of this Report. Accordingly, although the Dodd-Frank Act is expected to have significant impact on the financial system in the United States and beyond, the precise impact of Dodd-Frank Act on the investment climate remains uncertain. The following summarizes various proposed rules implementing the Dodd-Frank Act that are most relevant to the hedge fund industry.

*1. SEC's Proposed Rules on Private Investment Funds and Their Advisers*

On November 19, 2010, the SEC issued a series of proposed rules to implement various provisions of Title IV of the Dodd-Frank Act, including those related to the new exemptions from the registration requirement of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), for certain advisers (the "Proposed Exemption Rules") and those related to various registration and reporting requirements under the Advisers Act (the "Proposed Registration Rules").

New Sections 203(l), 203(m) and 203(b)(3) of the Advisers Act as enacted by the Dodd-Frank Act create new exemptions from registration under the Advisers Act for investment advisers who solely advise "venture capital funds" (the "venture capital fund exemption"), who solely advise "private funds"[2] that have less than $150 million in assets under management in the United States (the "private fund exemption"), and who are "foreign private advisers" (the "foreign private adviser exemption"), respectively. Under the Proposed Exemption Rules, the SEC proposed the adoption of Rule 203(l), which would define the term "venture capital fund" for purposes of the venture capital fund exemption; Rule 203(m), which would address several interpretive questions raised by the private fund exemption, including how the private fund exemption should apply to non-U.S. advisers and the method of calculating assets under management; and Rule 202(a)(3), which would define certain terms used in the foreign private adviser exemption, including "client," "investor," "in the United States," "place of business," and "assets under management."

The Proposed Registration Rules address, among others, the reallocation of responsibility for oversight of investment advisers by requiring certain mid-sized advisers (*i.e.*, those that have between $25 and $100 million of assets under management) to register with the states instead of the SEC, as well as the registration of many advisers to hedge funds, private equity funds, and venture capital funds as a result of the repeal of the "private adviser exemption" formerly contained in Section 203(b)(3) of the Advisers Act.

Although comments to both the Proposed Exemption Rules and the Proposed Registration Rules were due on January 24, 2011, the SEC continues to receive comments, and no final rules have yet been adopted. On April 8, 2011, in a letter to North American Securities Administrators Association ("NASAA"), the Associate Director of the SEC, Robert E. Plaze, indicated that the SEC expects to complete rulemaking related to the registration of mid-sized advisers with states and the newly created exemptions noted above by July 21, 2011 in accordance with the Dodd-Frank Act. In addition, the letter indicated that the SEC will also consider extending the compliance date under such rulemaking to first quarter of 2012. **Note that as of the date of this Report the SEC has not confirmed such an extension.**

On March 15, 2011, Representative Robert Hurt introduced the "Small Business Capital Access and Job Preservation Act" ("H.R. 1082"), which would amend the Advisers Act to provide an exemption from the registration requirement imposed on certain private equity fund advisers by the Dodd-Frank Act. H.R. 1082 was referred to the House Committee on Financial Services on March 15, 2011 and to the Subcommittee on Capital Markets and Government Sponsored Enterprises on April 4, 2011.

Additional information on the Proposed Exemptions Rules and the Proposed Registration Rules is available here.

*2. SEC's Recently Released Study on Investment Adviser Examination*

On January 19, 2011, the SEC released its "Study on Enhancing Investment Adviser Examination" (the "Study") as mandated by Section 914 of the Dodd-Frank Act. The SEC was required to conduct a study to review and analyze the need for enhanced examination and enforcement resources for investment advisers. The Study was organized in five parts: (1) the SEC's examinations of registered investment advisers' books, records and activities; (2) the number and frequency of examinations of registered investment advisers over the past six years; (3) the impact of the Dodd-Frank Act on the number and examinations of registered investment advisers; (4) options that Congress should consider in order to strengthen the SEC's investment adviser examination program; and (5) the SEC staff's recommendations respecting the examination capacity concerns identified earlier in the Study.

The SEC staff reported that over the past six years, the number of registered investment advisers had increased 38.5%, from 8,581 advisers to 11,888 advisers, and assets managed by registered investment advisers grew 58.9%, from $24.1 trillion to $38.3 trillion, while the number of SEC staff dedicated to examining registered investment advisers decreased 3.6%, from 477 staff members to 460 staff members. As a result, the number of adviser examinations conducted each year over the past six years decreased 29.8%, from 1,543 examinations in 2004 to 1,083 examinations in 2010, and only 9% of registered investment advisers were examined in 2010, a decrease from 18% in 2004. While the SEC staff expects a significant near-term decrease in the number of registered investment advisers because of the increased threshold of $25 million to $100 million for registration with the

SEC, the staff also believes that the SEC will still face "significant capacity challenges." To address these challenges, the SEC staff proposed three options: (1) the imposition of "user fees" on SEC-registered investment advisers to fund the investment adviser examination program; (2) the authorization of one or more self-regulatory organizations to examine, subject to SEC supervision, all SEC-registered investment advisers; or (3) the authorization of Financial Industry Regulatory Authority, Inc. ("FINRA") to examine dual registrants for compliance with the Advisers Act. Commissioner Elisse Walter released a statement expressing her disappointment with the results of the study.

Additional information on the Study is available here.

*3. SEC's and CFTC's Joint Proposal to Adopt Form PF for Private Fund Advisers*

On January 25, 2011 and January 26, 2011, the SEC and the CFTC jointly proposed the adoption of Form PF to implement certain provisions of Title IV of the Dodd-Frank Act. The SEC proposed Rule 204(b)-1 under the Advisers Act, under which SEC-registered investment advisers that advise one or more private funds ("Private Fund Advisers") would be required to report certain risk, leverage and financial information regarding those private funds on the newly created Form PF. Similarly, the CFTC proposed Regulation 4.27, under which Private Fund Advisers that are also registered with the CFTC as commodity pool operators ("CPOs") and/or commodity trading advisors ("CTAs") with the CFTC would be required to file Form PF in respect of any private funds advised by such dual registrants.

The amount of information required to be reported and the frequency of the reporting by an adviser are dependent on the assets under management and the types of private funds managed by the adviser. It is anticipated that most Private Fund Advisers would be subject to the lower reporting requirements. The information to be collected on Form PF is intended to assist the Financial Stability Oversight Council ("FSOC") in monitoring the potential systemic risks posed by private funds.

Additional information on proposed Form PF is available here.

*4. CFTC's Proposal to Adopt Amendments to Compliance Obligations of CPOs and CTAs*

On January 26, 2011, the CFTC proposed amendments to the compliance obligations of CPOs and CTAs that, among others, would rescind or modify several CFTC registration exemptions and exclusions commonly relied upon by private investment fund sponsors (the "CPO/CTA Amendments"). Specifically, the CPO/CTA Amendments would rescind the exemption from CPO registration for operators of commodity pools that have limited futures activity as set forth in CFTC Regulation 4.13(a)(3), and the exemption for operators of commodity pools that restrict participation to certain sophisticated investors as set forth in CFTC Regulation 4.13(a)(4). Many sponsors of private investment funds currently rely on these exemptions.

The CPO/CTA Amendments would also reinstate trading criteria for registered investment companies claiming an exclusion under CFTC Regulation 4.5 such that such investment companies could neither be marketed as vehicles for gaining commodity exposure, nor engage in more than a *de minimis* amount of futures and options activity (other than for bona fide hedging purposes) without first registering as CPOs with the CFTC. This could also have the consequence of requiring advisers to such registered investment companies to register as CTAs with the CFTC.

The CFTC separately proposed the CPO/CTA Amendments shortly after the announcement of the joint proposal on Form PF with the SEC as discussed above. The CFTC believes that the CPO/CTA

Amendments are necessary in order to oversee participants in the commodity futures and derivatives markets effectively better in light of the recent economic turmoil and that they are consistent with the spirit of the Dodd-Frank Act.

Additional information on the CPO/CTA Amendments is available here.

*5. SEC's Approval of Interagency Proposal on Inventive-Based Compensation Arrangements*

On March 2, 2011, as part of a joint rulemaking effort with various other agencies, the SEC proposed rules to implement Section 956 of the Dodd-Frank Act with respect to incentive-based compensation practices at "covered financial institutions"[3] with assets of no less than $1 billion (the "Proposed Incentive-Based Compensation Rules").

Under the Proposed Incentive-Based Compensation Rules, a "covered financial institution" would include, in the case of the SEC, a broker-dealer registered under Section 15 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and an "investment adviser," as such term is defined in Section 202(a)(11) of the Advisers Act, whether or not the investment adviser is registered under the Advisers Act.

The Proposed Incentive-Based Compensation Rules have four major components: (1) the prohibition against incentive-based compensation arrangements at a covered financial institution that encourage executive officers[4], employees, directors[5], or principal shareholders (collectively, "covered persons") to expose the institution to inappropriate risk by providing the covered persons with excessive compensation; (2) the prohibition against a covered financial institution establishing or maintaining any incentive-based compensation arrangements for covered persons that encourage inappropriate risks by the covered financial institution that could lead to material financial loss; (3) the requirement that a covered financial institution adopt policies and procedures appropriate to its size, complexity, and use of incentive-based compensation to help ensure compliance with the requirements and prohibitions contained in the Proposed Incentive-Based Compensation Rules; and (4) the requirement that a covered financial institution report annually certain information to its appropriate federal regulator(s) concerning its incentive-based compensation arrangements for covered persons.

In addition, the Proposed Incentive-Based Compensation Rules would also establish a deferral requirement applicable to larger covered financial institutions (*i.e.*, generally those with $50 billion or more in total consolidated assets) mandating that at least 50 percent of the incentive-based compensation of an executive officer be deferred over a period of at least three years. Since the SEC approved the Proposed Incentive-Based Compensation Rules, all remaining participating agencies have also approved the proposed rule release, and comments are to be received by the respective participating agencies by May 31, 2011.

Additional information on the Proposed Incentive-Based Compensation Rules is available here.

*6. Federal Reserve's Proposed Rule Relating to Nonbanking Financial Companies*

On February 8, 2011, the Federal Reserve requested comments to a proposed rule, which would establish the requirements for determining if a company is "predominantly engaged in financial activities" for purposes of Title I of the Dodd-Frank Act and would define the terms "significant nonbank financial company" and "significant bank holding company." The proposed rule is relevant to provisions of the Dodd-Frank Act, including Section 113, which authorizes FSOC to require a "nonbank financial company" to be subject to consolidated, prudential supervision by the Federal Reserve if

FSOC determines that material financial distress at or activities of the company could pose a threat to the financial stability of the United States.

Section 113 also provides a number of criteria that FSOC must consider in determining whether a company poses systemic risks and should be subject to the supervision of the Federal Reserve. FSOC has also recently requested comments on a proposed rule implementing Section 113 of the Dodd-Frank Act. Because the Federal Reserve defines those terms broadly, the proposed rule may capture, among others, the largest hedge funds and private equity funds.

Additional information on the Federal Reserve's proposed rule relating to nonbanking financial companies is available here.

### *B. Other New and Proposed Securities-Related Legislation and Regulation*

*1. DOL's Proposal to Expand Definition of "Fiduciary"*

On October 21, 2010, the Department of Labor (the "DOL") issued a proposed rule that would amend a 1975 regulation to define "fiduciary" more broadly as a person who provides investment advice to plans for a fee or other compensation for purposes of the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

The existing 35-year-old regulation creates a five-part test that must be satisfied in order for a person to be treated as a fiduciary by reason of rendering investment advice. The proposed rule would replace the five-part test with one that is easier to satisfy as a result of, among others, the elimination of the requirement that the advice is provided on a regular basis and the broadening of the types of activities that would constitute investment advice. As a result of the expanded definition of "fiduciary," various hedge fund industry participants, including hedge fund investment advisers, placement agents, appraisers and valuation firms, and pension plan consultants, could be affected. The DOL proposed the change because it believes that the existing regulation may inappropriately limit the types of investment advice relationships that give rise to fiduciary duties on the part of the investment adviser in light of significant changes in the marketplace, the increased types and complexity of investment products and services available to plans, and the changes in the relationships between the advisers and their plan clients. Comments to the proposed rule were initially due on January 20, 2011, but due to the large number of comments received, the DOL has extended the comment period to April 12, 2011, 15 days after the official transcript of the March 1-2, 2011 hearing was posted on DOL's website on March 28, 2011.

Additional information on the DOL's proposal to expand the definition of fiduciary is available here.

*2. Delayed Effective Date of DOL's ERISA Regulations on Fee Disclosure*

On July 16, 2010, the DOL published an interim final regulation under Section 408(b)(2) of ERISA that requires improved disclosures by service providers to facilitate pension plan fiduciaries in assessing the reasonableness of the compensation to be paid to service providers and potential conflicts of interest that may affect the performance of services to be provided. The interim final regulation was to take effect on July 16, 2011. However, on February 11, 2011, the DOL announced that it intends to extend the effective date for the new disclosure rules to January 1, 2012 to ensure a careful review of comments received by the DOL as well as sufficient time for plans and service providers to engage in compliance efforts.

*3. FINRA's New Rule 5131 on New Issue Allocation and Distribution*

On September 29, 2010, the SEC approved the adoption of FINRA Rule 5131. The National Association of Securities Dealers, Inc. (NASD) initially proposed the rule on September 13, 2003, which was subsequently amended four times. On November 29, 2010, FINRA issued Regulatory Notice 10-60 setting the effective date of the new rule as May 27, 2011. The new rule establishes certain requirements with respect to the allocation, pricing and trading of new issues (*i.e.*, an initial public offering ("IPO") of an equity security as defined in Section 3(a)(11) of the Exchange Act made pursuant to a registration statement or offering circular). The new rule does not replace, but rather supplements, existing FINRA Rule 5130. In particular, the new rule prohibits the allocation of new issues by a FINRA member in order to obtain a "kick back" in the form of executive compensation relative to other services offered by the FINRA member (the so-called *quid pro quo* allocation), as well as the allocation of new issues by a FINRA member to any prohibited account, *i.e.*, an account in which an executive officer or director of a public company or a covered non-public company[6], or a person materially supported by such executive officer or director, has a beneficial interest, if the company is a current or certain former or prospective investment banking client of such FINRA member (an activity known as "spinning"). The new rule also regulates the conduct of FINRA members in the IPO process, including the practice of "flipping," reports of indications of interest to an issuer's pricing committee, and the application of lock-up agreements. Additional information on the new FINRA Rule 5131 is available here .

***C. Other Updates***

*1. The Emergency Mortgage Relief and Neighborhood Stabilization Programs Cost Recoupment Act of 2011*

On March 17, 2011, Representative Barney Frank introduced "The Emergency Mortgage Relief and Neighborhood Stabilization Programs Cost Recoupment Act of 2011" (the "Recoupment Act"), which was referred to the House Committee on Financial Services. The Recoupment Act would amend the Dodd-Frank Act to direct the Secretary of the Treasury, in order to recoup the amount of assistance made available under the Emergency Mortgage Relief and Neighborhood Stabilization Programs, to make risk-based assessments in the total amount of $2.5 billion on (1) financial companies that manage hedge funds with $10 billion or more in assets under management on a consolidated basis; and (2) other financial companies with $50 billion or more in total consolidated assets, subject to terms and conditions that the Secretary of Treasury may establish with the concurrence of certain other agencies. A similar proposal was introduced in the last Congress but did not receive enough support to become law. Additional information on the Recoupment Act is available here.

*2. NASAA's Proposed Changes to Model Rules on Custody and Brochure Delivery Requirements for State Investment Advisers*

On February 17, 2011, the comment period (14 days until March 2, 2011) began for the proposed changes to the NASAA Model Rules on investment adviser custody, financial requirements, recordkeeping and brochure delivery. The proposed changes to the NASAA Model Rules were prompted by the recent changes to the SEC custody rules and the SEC brochure rules applicable to SEC-registered advisers. Among other things, the proposed changes to the NASAA Model Rules would clarify or add certain definitions and clarify or modify certain requirements applicable to state investment advisers, all of which are intended to preserve the increased investment protection afforded by states while making the NASAA Model Rules more consistent with the current SEC custody and brochure rules following the recent rule changes. Additional information on the proposed changes to the NASAA Model Rules is available here.

*3. EU AIFM Directive*

In response to the world financial market meltdown in 2008, the European Commission first unveiled a draft Directive on Alternative Investment Fund Managers (the "AIFM Directive") on April 30, 2009. The AIFM Directive is aimed to create a comprehensive and effective regulatory and supervisory framework for alternative investment fund managers ("AIFM"), which encompass managers to hedge funds, private equity funds, real estate funds and a wide range of other types of institutional funds. On November 11, 2010, after months of difficult negotiations, the European Union ("EU") Parliament by a very large majority vote approved the final text of the AIFM Directive. Subject to the formal approval by the European Council, the AIFM Directive is expected to become effective in early 2011 and be applied to members of the EU by 2013.

One of the most important concepts introduced by the AIFM Directive is the "passport," or a "single market framework," concept, which allows AIFMs to manage and/or market funds throughout the EU with the authorization of only one single EU member state. Although the stated goal of the AIFM Directive is to regulate AIFMs within the EU, as suggested by the title of the directive, the AIFM Directive also provides for regulation of funds and will have significant impact on fund service providers, and the reach of the AIFM Directive goes beyond the territory of the EU. According to a recent poll conducted by PricewaterhouseCoopers, LLC, the vast majority of AIFMs did not have a plan to implement the mandates of the AIFM Directive. As the AIFM Directive draws closer to becoming effective, AIFMs should begin considering the impact of the AIFM Directive on their businesses and the actions they may need to take in response to this comprehensive regulatory framework. Additional information on the final rules on shareholder proxy access is available here.

## II. TAXATION

One of the noteworthy tax developments since our last Report relates to President Obama signing into law the Tax Relief, Unemployment Insurance Reauthorization, and Jobs Creation Act of 2010 (the "Act"). The Act extends all Bush-era tax cuts for two additional tax years (through December 31, 2012), along with other important "tax extenders". Note that the Act does not include provisions addressing the taxation of "carried interests" or the S-Corporation self-employment ("SE") tax. With a new Republican-controlled House in 2011 and 2012, it seems unlikely that the "carried interest" or the S-Corporation SE tax provisions will be repealed during this session of Congress.

The Act and the shift in political power in Congress should translate to positive news for investment advisers. Managers can continue to structure private funds with profit allocation provisions that can take advantage of favorable long term capital gain tax rates.

### *A. Foreign Account Tax Compliance Act*

On April 8, 2011 the Internal Revenue Service ("IRS") released Notice 2011-34 ("Notice"), a much-anticipated, detailed guidance on the reporting and withholding requirements under the Foreign Account Tax Compliance Act ("FATCA").

The Notice addresses several areas of concern for foreign financial institutions ("FFIs"), which will be the *de facto* administrators of the FATCA reporting regime. FATCA, which was enacted in March 2010 in the Hiring Incentives to Restore Employment Act (the "HIRE Act"), requires FFIs to report "U.S.

accounts" to the IRS or pay a 30% withholding tax on any withholdable payments made to the institutions or their affiliates.

The Notice supplements Notice 2010-60 (on which we summarized in the last Report) and responds to concerns identified by commentators following its publication.

*1. Determination of Whether Accounts Have United States Owners*

Notice 2010-60 sets forth rules for identifying which accounts have U.S. owners. In reaction at least in part to practical concerns raised by FFIs in response to Notice 2010-60, the Notice replaces the rules for identification of preexisting individual accounts. The new rules distinguish "private banking accounts" from other depository accounts and impose greater responsibilities on FFIs to identify whether such private banking accounts have U.S. owners. The Notice also revises the remainder of the six-step process set forth in Notice 2010-60 for identification of preexisting accounts.

*2. Passthru Payments*

"Passthru payments" are payments that are attributable to payments that require withholding ("withholdable payments"). Participating FFIs may be required to withhold 30% of a passthru payment that is made to a noncompliant FFI or an account holder who has failed to verify its U.S. or non-U.S. status (a "recalcitrant account holder"). The IRS has responded to comments about the difficulty of tracing the source of each particular payment for FFIs such as investment funds by instituting a passthru payment withholding regime based on the percentage of an FFI's assets that can give rise to withholdable payments. Each such FFI must calculate its "passthru payment percentage" ("PPP") to determine which portion of a passthru payment is subject to withholding. Each FFI must publish its PPP, or it will be deemed to have a PPP of 100% and must withhold 30% of its total payments to non-compliant FFIs or recalcitrant account holders.

Passthru payments on custodial accounts (where the FFI is acting as a custodian, broker or other agent) are also subject to withholding by the FFI, based on the nature of the securities held in the account, or, in the case of an interest in another FFI, the PPP of that FFI.

*3. Certain FFIs to be Deemed Compliant*

The Notice provides that certain categories of FFIs will be "deemed compliant" with FATCA. Although an entity that is "deemed compliant" need not undertake FATCA reporting or withholding responsibilities, the entity must apply for deemed compliant status with the IRS, obtain an FFI identification number, and certify to the IRS every three years that it continues to meet the requirements for deemed compliant status. The Notice grants this status only to certain local banks, local FFI members of participating FFI groups, and a very limited category of investment vehicles.

According to the Notice, the IRS is considering "deemed compliant" treatment for (a) foreign retirement accounts and plans and (b) certain collective investment vehicles and other investment funds if: (i) all holders of record of direct interests in the fund are participating FFIs, deemed-compliant FFIs holding on behalf of other investors, or certain other entities such as a foreign government; (ii) the fund prohibits the subscription for or acquisition of any interests in the fund by any person that is not of one of these types; and (iii) the fund certifies that its PPP will be calculated and published in accordance with the Notice.

*4. Reporting on U.S. Accounts*

The Notice modifies the rules set forth in Notice 2010-60 for determining and reporting a U.S. account's (i) account balance or value and (ii) gross receipts and withdrawals, generally allowing FFIs to rely on existing procedures and practices. The Notice also states that the generally applicable "basis reporting" rules will not apply to FFIs that are not U.S. payors and that comply with FATCA reporting.

*5. Qualified Intermediaries*

A Qualified Intermediary ("QI") that is subject to FATCA reporting must consent to include in its QI agreement the requirement to become a participating FFI, unless it qualifies as a deemed-compliant FFI. This requirement will apply to all QIs on January 1, 2013. Similar rules will apply to FFIs currently acting as foreign withholding partnerships.

*6. Expanded Affiliated Groups of FFIs*

The Notice states that the IRS intends to require each FFI affiliate in an FFI-affiliated group to be a participating FFI or a deemed compliant FFI. Each such affiliate must enter into an FFI agreement that will apply to all of its worldwide branches and offices. The Notice sets forth a coordinated application process and coordinated execution procedures, with each FFI affiliated group to have a "lead FFI" that serves as the primary liaison with the IRS. The Notice also suggests a centralized compliance option for FFI-affiliated groups and certain investment funds.

7. Next Steps

The IRS reaffirms in the Notice its intention to issue proposed regulations incorporating the guidance provided in the Notice and Notice 2010-60 and to publish draft FFI agreements and draft information reporting and certification forms, though the Notice does not provide target release dates for this guidance.

***B. Recent FBAR Developments***

As discussed in previous issues of our Report, U.S. persons who have an interest in or signatory authority over a foreign account with a value over $10,000 are required to file a Foreign Bank Account Report ("FBAR"). The IRS has been actively calling for FBAR compliance. Significant civil and criminal penalties await those who fail to file FBARs. The IRS has provided additional guidance on those who are required to file FBARs, filing deadlines and how those who failed to file FBARs may achieve compliance. On February 26, 2010, the IRS issued Announcement 2010-16 and Notice 2010-23. The announcement provided retroactive relief from FBAR filing for foreign entities and persons while the notice extended the FBAR filing deadline for some taxpayers who have signature authority and who own commingled funds to June 30, 2011. It also clarified that interests in private investment vehicles like private equity funds and hedge funds will not be considered foreign financial accounts, and thus need not be reported on an FBAR, for 2009 or prior years. On the same date, the Treasury Department issued proposed rules that would provide both FBAR filing clarification and relief.

*1. Additional Disclosure on Tax Returns*

In addition to filing a FBAR, for tax years beginning after March 18, 2010, the HIRE Act provides that individuals with an interest in a "specified foreign financial asset" during the tax year must attach a disclosure statement to their income tax return for any year in which the aggregate value of all such assets is greater than $50,000.

Individuals who fail to make the required disclosures are subject to a penalty of $10,000 for the tax year. An additional $10,000 penalty for each 30 days of failure to disclose (or fraction of such 30-day period) applies if the failure to disclose continues for more than 90 days after notice by the IRS, up to a $50,000 maximum penalty.

To the extent the IRS determines that an individual has an interest in one or more specified foreign financial assets, and such individual does not provide sufficient information to enable the IRS to determine the aggregate value of such assets, the aggregate value of such assets is presumed to exceed $50,000 for penalty purposes.

*2. Penalty Imposed on Undisclosed Foreign Financial Assets Understatement*

For tax years beginning after March 18, 2010, a 40% penalty is imposed on any understatement attributable to an undisclosed foreign financial asset. This new penalty is double the penalty for underpayment on U.S. assets. The term "undisclosed foreign financial asset" includes all assets subject to information reporting requirements, *i.e.*, a U.S. person who controls a foreign corporation or partnership or a U.S. person who makes certain "outbound" transfers to foreign entities or acquires or disposes of certain foreign partnership interests or whose proportional interest in a foreign partnership changes substantially.

*3. Additional FBAR Developments*

On February 24, 2011, the Treasury Department published final regulations amending the FBAR regulations. While the language in the final regulations is substantially consistent with the proposed FBAR rules that were published one year ago, the final regulations clarify and revise certain provisions regarding which persons will be required to report accounts and which accounts will be reportable, as well as any specific exceptions to the filing requirements. These regulations are effective as of March 28, 2011, and apply to FBARs required to be filed with respect to foreign financial accounts maintained in calendar year 2010 and for FBARs required to be filed with respect to all subsequent calendar years.

In Notice 2011-31, the IRS clarified that in answering FFA-related questions on 2010 tax and information returns (for instance, Schedule B of Form 1040) filed before March 28, 2011 (*i.e.*, the effective date of the final FBAR regulations), a taxpayer may either reference (i) the existing FBAR regulations (last amended April 1987), which remain effective, along with other then-existing FBAR guidance; or (ii) the final FBAR regulations and revised FBAR instructions, including the draft instructions. However, the IRS will take into account the final FBAR regulations and revised FBAR instructions in considering the reasonableness of a taxpayer's response to such questions.

## III. CIVIL LITIGATION

Hedge funds continue to be embroiled in litigation, both as defendants and plaintiffs, over a wide variety of issues. As described more fully below, in an action brought by a group of hedge funds against a German company, the Southern District of New York ruled that Section 10(b) of the Exchange Act does not apply to swap agreements that reference foreign stocks. Further, S.A.C. Capital Advisors and Biovail settled their long-running legal battle over short sales that allegedly drove down the price of Biovail's stock. A FINRA arbitration award against prime broker Goldman Sachs for failure to investigate its hedge fund customer's fraud was confirmed by the Southern District of New York. Prime broker Morgan Stanley and a hedge fund filed claims against each other relating to the tripling of a trading account margin requirement that caused the hedge fund to default. The New York Appellate Division ruled that a hedge fund compliance officer employed "at-will" who was terminated in retaliation for investigating fraud has no state law remedy. Finally, courts in the Cayman Islands and the British Virgin Islands have decided a number of cases relating to the rights of hedge fund investors to petition for liquidation.

### *A. Update on Previously Reported Cases*

Many of the cases reported in previous issues of our Report continue to progress through litigation.

*1. Section 10(b) Does Not Apply to Swap Agreements Referencing Foreign Securities:* Elliott Associates v. Porsche Automobil Holding SE

In the Spring 2010 issue of our Report, we reported that a group of hedge funds had sued Porsche for concealing its intent to acquire Volkswagen and for its use of allegedly manipulative trades to hide its true stock positions. According to the plaintiff hedge funds, who were all short sellers in Volkswagen AG stock, Porsche's misrepresentations violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and caused the hedge funds to lose over $2 billion in covering their short positions.[7] After the hedge funds' complaint was amended following the Supreme Court's decision in *Morrison v. National Australia Bank*,[8] Porsche moved to dismiss on the grounds that the antifraud provisions of Section 10(b) did not apply to transactions in securities that are not listed on U.S. exchanges.

On December 30, 2010, the Southern District of New York agreed with Porsche and dismissed all of the hedge funds' claims. The court explained that *Morrison* limited the application of Section 10(b) to transactions in securities listed on domestic exchanges and to domestic transactions in other securities.[9] The hedge funds had entered into domestic securities-based swap agreements that referenced foreign Volkswagen stock; thus, they argued that they had entered into "domestic transactions in other securities" within the scope of Section 10(b). The court, however, found that the swap agreements were "the 'functional equivalent' of trading the underlying Volkswagen shares on a German exchange,"[10] and stated that it was "loathe to create a rule that would make foreign issuers with little relationship to the U.S. subject to suits here simply because a private party in this country entered into a derivatives contract that references the foreign issuer's stock."[11] The hedge funds appealed to the Second Circuit on January 28, 2011.

One question that arises following the decision in *Porsche* is whether it presages a trend toward extending *Morrison* even beyond its original scope. If it does, hedge funds dealing in foreign issuers' stocks – or even entering into derivative contracts that reference a foreign issuer's stock – will find themselves without a securities fraud remedy in U.S. courts.

*2. S.A.C. Capital Settles Lawsuit with Biovail Over Vexatious Litigation*

In the Spring 2010 issue of our Report, we reported that the protracted dispute between hedge fund S.A.C. Capital Advisors and pharmaceutical company Biovail had opened a new chapter. The dispute began in February 2006 when Biovail sued S.A.C. Capital for participating in an illegal short sale scheme in order to drive down Biovail's stock price. After the New Jersey Superior Court dismissed all of Biovail's claims in August 2009, S.A.C. Capital filed a complaint against Biovail in February 2010, seeking damages for vexatious suit and abuse of process.[12]

The legal battle between S.A.C. Capital and Biovail (which merged with and is now known as Valeant Pharmaceuticals International) is now over. The parties settled in November 2010, with Valeant agreeing to pay $10 million to S.A.C. Capital.[13]

### *B. New Developments in Securities Litigation*

*1. <u>S.D.N.Y. Confirms FINRA Award Against Prime Broker for Failure to Investigate Fraud Committed by Hedge Fund Customer</u>*

The Southern District of New York denied a petition by Goldman Sachs Execution and Clearing, L.P. (GSEC) to vacate a FINRA arbitration award requiring GSEC to pay over $20 million to the Official Unsecured Creditors' Committee of Bayou Group, LLC.[14] The court also granted the Committee's cross-petition to confirm the award.

Bayou Group, LLC opened a prime brokerage account with GSEC for hedge fund Bayou Fund, LLC in 1999. The fund's principal, Samuel Israel, later opened accounts with GSEC for four affiliated hedge funds. In 2003, Israel transferred approximately $14 million from Bayou Fund's margin account to the margin accounts of the four other hedge funds. In 2004 and 2005, Bayou Group deposited approximately $7 million into the margin account of Bayou Fund. Israel closed the hedge funds in 2005, and it was soon discovered that he had operated a Ponzi scheme and fraudulently concealed trading losses from the hedge funds' investors. After the hedge funds filed for Chapter 11 bankruptcy, the Committee was appointed to represent the unsecured creditors' interests.

In 2008, the Committee filed a FINRA arbitration claim alleging that GSEC, as prime broker and clearing broker to the five Bayou hedge funds, failed to investigate Israel's Ponzi scheme and was jointly and severally liable with the funds for fraudulent conveyances. GSEC answered that: (1) the transfers of money between the prime brokerage accounts were not fraudulent conveyances because the five hedge funds were one and the same entity, and (2) that GSEC, as a clearing and execution firm, exercised no "dominion or control" over Bayou's assets and therefore could not be liable for failure to investigate Israel's fraud.

On June 27, 2010, the arbitration panel awarded the Committee the full amount of damages it sought from GSEC. The panel did not give reasons for its decision, but the Southern District of New York addressed GSEC's arguments on why the award should be vacated and ruled that there was no manifest disregard of the law.

*2. <u>Hedge Fund Sues Prime Broker for Tripling Margin Requirements:</u>* <u>Morgan Stanley v. Peak Ridge</u>

Prime broker Morgan Stanley and hedge fund Peak Ridge filed claims against each other in November 2010.[15] The claims concerned a futures trading account that Peak Ridge opened with Morgan Stanley in 2009. As part of the parties' Customer Agreement, Morgan Stanley imposed a 2:1 net liquidation value to risk ratio as the margin requirement. As Peak Ridge undertook more risk in its account, Morgan Stanley raised the ratio to 6:1 by June 9, 2010 and warned Peak Ridge that failure to maintain the margin would constitute an event of default. On June 10, 2010, Morgan Stanley declared Peak Ridge in default and terminated Peak Ridge's access to its account.

Morgan Stanley filed suit on November 8, 2010, claiming over $40 million in losses from Peak Ridge's failure to meet its contractually required margin calls. On November 29, 2010, Peak Ridge filed a counterclaim, alleging that Morgan Stanley acted in a commercially unreasonable manner by: (1) tripling the margin requirement within a matter of a few months, (2) giving notice of default without making a margin call, and (3) selling Peak Ridge's remaining open positions to a Morgan Stanley-affiliated competitor. This action is still in its infancy.

*3. Compliance Officers Who Are Employed "At-Will" Have No Breach of Contract Cause of Action for Retaliatory Termination:* Sullivan v. Harnisch

The New York State Appellate Division recently held that an employed-at-will compliance officer for a hedge fund has no state law remedy for being terminated in retaliation for investigating fraud. In *Sullivan v. Harnisch*,[16] the plaintiff Sullivan was the Chief Compliance Officer for Peconic Partners LLC and Peconic Asset Managers LLC. In 2008, Sullivan investigated Peconic's president for taking personal advantage of investment opportunities that should have first been given to the fund's clients. This practice, known as "front-running," was prohibited by Peconic's Code of Ethics and Sullivan, as Chief Compliance Officer, initiated an investigation of the alleged activity. However, Peconic's president fired Sullivan before he could complete his investigation.

Sullivan filed suit, alleging that his termination breached an implied contract with Peconic that he would not be terminated in retaliation for investigating fraud. The Appellate Division disagreed, unanimously holding that an at-will employee has no cause of action for his termination, "absent a constitutionally impermissible purpose, a statutory proscription, or an express limitation in the individual contract of employment. . . ."[17] Expressing its unwillingness to intrude on employment relationships, the court explained that Sullivan's duty to ensure compliance did not create an implied contract protecting Sullivan from retaliatory termination.

The impact of *Sullivan* should not be overstated. The only relevant cause of action on appeal was a New York state claim for breach of implied contract; a different outcome could certainly have resulted if different causes of action were at issue, or if Sullivan had reported the front-running practice to the SEC.

*4. Liquidation Disputes*

Several recent cases originating in the Cayman Islands and the British Virgin Islands have addressed the rights of investors to petition that a hedge fund be liquidated.

*a. Culross Global SPC Ltd. v. Strategic Turnaround Master Partnership Ltd.*

On appeal from the Cayman Islands Court of Appeal, the Privy Council ruled that an investor who requested redemption from a hedge fund but did not receive payment by the redemption date had standing to petition for liquidation.[18] The Privy Council explained that an investor who requests redemption from a fund becomes a creditor on the intended date of redemption (and not on the date of actual payment). Because investor Culross did not receive redemption payment from hedge fund Strategic Turnaround by the redemption date, Culross became a creditor with full rights to petition for the winding up of the fund.

The Privy Council's analysis suggests that Strategic Turnaround's Articles of Association could have compelled a different outcome in the case if there were explicit provisions allowing the fund to suspend redemptions after the redemption date has passed. Hedge funds are advised to review their Articles of Association and to amend if necessary in order to avoid similar litigation.

*b. Aris Multi-Strategy Lending Fund Ltd. v. Quantek Opportunity Fund, Ltd. and In the Matter of the Companies Law and in the Matter of Heriot African Trade Finance Fund Ltd.*

Aris Multi-Strategy Lending Fund Ltd. was the plaintiff in two recent cases involving an investor's right to petition for the liquidation of a hedge fund. Both cases discuss the point at which a hedge fund loses its "substratum," or the point at which the hedge fund can no longer carry out its business purpose and minority shareholders can thereby petition for liquidation on "just and equitable" grounds.

In *Aris v. Quantek*,[19] Aris petitioned for the court-supervised liquidation of hedge fund Quantek after the fund permanently suspended redemptions and adopted a reorganization plan that would allow it to liquidate over three years. The British Virgin Islands High Court denied the petition, ruling that Quantek had not lost its substratum despite the suspension of redemptions because it was still possible for Quantek to continue its business of holding investments.

However, in *In the Matter of Heriot*,[20] the Cayman Islands Court of Appeal granted Aris's request for the court-supervised liquidation of hedge fund Heriot because the fund had permanently suspended redemptions and thereby lost its substratum. According to the court, "it is impossible for the Fund to carry on its original business in the sense that it will not make any new investments or enter into any new trade finance transactions."[21]

The cases can perhaps be reconciled by examining the character of the two defendant hedge funds. Quantek was a "feeder fund" whose sole business purpose was to invest all its assets in a master fund– thus, Quantek's suspension of redemptions did not impair its ability to continue holding its interests. Heriot, on the other hand, actively traded in commodities and provided financing for third party transactions in commodities. Because the suspension of redemptions made new investments impossible for Heriot, it was appropriate for the court to rule that there was a loss of substratum in that case.

## IV. REGULATORY ENFORCEMENT

Now three years removed from the heart of the global financial crisis, the SEC shows no signs of slowing down its enforcement activities involving hedge funds. For instance, SEC enforcement director Robert Khuzami told a House Financial Services subcommittee in March that the SEC would be scrutinizing hedge funds that consistently offer above-market returns.[22] Armed with special units designed specifically to detect and root out fraudulent activity, the SEC's recent statement is further proof that it will continue to scrutinize hedge fund activities. Hedge funds should be prepared to document their investment strategies and returns in detail, particularly with respect to the auditing and accounting functions responsible for ensuring the accuracy of numbers reported to investors. In addition, the SEC continues to examine the use of side pockets, Ponzi schemes and trading on inside information. Below are some key recent enforcement actions regarding these and other types of allegedly fraudulent activity being investigated by the SEC.

### *A. Side Pockets*

Side pockets are used by hedge funds to separate certain assets, typically illiquid assets, from the remainder of the fund's assets. If an investor redeems his or her investment in a hedge fund with a side pocket, the investor is not permitted to redeem the pro-rata portion of their investment allocated to the side pocket. That portion of the redemption is postponed until the asset is liquidated or released from the side pocket. Typically, hedge funds utilize side pockets when a fund has a large amount of illiquid assets in its portfolio. For that reason, the SEC has taken a keen interest in the use of side pockets, and recently filed an action against a hedge fund manager who was alleged to have improperly used side pocket funds.

*Baystar Capital II LP*

On March 1, 2011, the SEC announced that Lawrence Goldfarb and his company, Baystar Capital II LP, agreed to settle with the SEC, without admitting or denying the allegations, and to pay $14 million in connection with allegations that Baystar misappropriated $12 million of investors' money by illegally using side pocket investments. Goldfarb and his company were alleged to have violated Sections 206(1), (2), and (4) of the Advisers Act and Rule 206(4)-8 thereunder. According to the SEC, Goldfarb channelled side pocket money to other entities controlled by Goldfarb, and then used the money to invest in real estate and a record company.

The SEC alleged that Goldfarb and Baystar provided investors with phony account statements that showed that there had been no gains in the side pocket when, in reality, the side pocket investments had become profitable beginning in 2006. Investors were, as a result, unaware that they were entitled to distributions.

"Hedge fund managers may not use side pockets to obscure their activities from investors. Hedge fund investors need to honor their obligations to investors, and investors should pay close attention to the discretion that managers wield over side-pocketed investments," said Robert Kaplan, co-chief of the SEC Enforcement Division's Asset Management Unit.

Under the terms of the settlement, Goldfarb agreed to disgorge some $12 million and to pay prejudgment interest of nearly $2 million. Goldfarb will also pay a $130,000 civil penalty.[23]

***B. Pipes***

The SEC continues to investigate individuals and hedge funds that use non-public information obtained during PIPE offerings while trading the issuers' stocks. PIPE transactions typically involve a public company offering unregistered, restricted shares to investors at a discount to the market price of the company's publicly-traded shares. The issuer often agrees to file a subsequent registration statement within an agreed upon period of time so that investors can sell their shares. Below are two recent cases involving the alleged improper use of information relating to PIPE offerings. The first involves a case against an attorney who issued false opinion letters; the second involves a company's CEO's trading.

*1. Louis Zehil*

On February 28, 2011, Louis Zehil, a former McGuireWoods LLP attorney who was charged with violations of Sections 5(a), 5(c) and 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, was sentenced to three years in prison and three years of supervised release, and was ordered to forfeit some $17 million that he made, and to pay restitution to the victims and a $10,000 fine.[24] Zehil acted as attorney to various issuers in their PIPE offerings. Zehil admitted to sending false opinion letters to the issuers' stock transfer agents that directed the agents to issue unrestricted shares to entities that he controlled. After receiving the purportedly unrestricted shares, Zehil allegedly placed the shares into securities trading accounts that he controlled, and then sold them prior to the filing of registration statements.

2. *CytoCore*

On January 13, 2011, the SEC filed suit against Daniel Burns, chairman of CytoCore, Inc. ("CytoCore") from December 2007 to March 2008, for trading in CytoCore's stock ahead of a PIPE offering and various disclosure violations.[25] The SEC claims that Burns violated Section 17(a) of the Securities Act, as well as Sections 10(b), 14(a), 15(a), and 16(a) of the Exchange Act.

From December 2007 to March 2008, unbeknownst to the public, CytoCore sought to raise $10 million through a PIPE offering. In late January 2008, Burns invested $500,000 of his money in CytoCore's PIPE offering. At this time, Burns is alleged to have encouraged Robert McCullough, Jr., CytoCore's Chief Executive Officer and Chief Financial Officer to invest in CytoCore's PIPE offering as well. After their initial investment, Burns encouraged McCullough in early February 2008 to invest more money so that they could issue a joint press release announcing insider buying to the tune of $800,000 to $900,000. After making additional purchases in early February 2008, Burns filed a Form 4 disclosure form with the SEC reporting his investments. After filing the Form 4, Burns issued a press release, stating in part, "We [Burns and McCullough] believe that our investment illustrates our commitment to generating shareholder returns for our investors, as well as our confidence in the strategy we are implementing to generate those returns." CytoCore's stock price closed 9.5% higher after the release. The day after the press release, CytoCore announced that the Food and Drug Administration approved the sale of SoftPAP in the United States. CytoCore's stock climbed a further 14.8%.[26]

The day after publicly announcing his investment in CytoCore, Burns opened a new brokerage account and delivered some 120,000 CytoCore shares into the account. Burns falsely stated on the account opening form that he was not an officer or director of a public company. Thereafter, in February and March 2008, Burns began selling shares in CytoCore, earning hundreds of thousands of dollars in proceeds.

When CytoCore publicly announced the PIPE offering in mid-March 2008, CytoCore's stock price fell 19.6% over a two day period. By selling CytoCore before announcing the results of the PIPE offering, Burns was able to avoid losses associated with the decline in CytoCore's stock price. After the announcement, Burns allegedly re-invested in CytoCore at the significantly reduced stock price.

In addition to Burns, the SEC's complaint also accuses McCullough of various violations of securities laws, including failing to disclose his trading in CytoCore securities, as required by federal law. The SEC is seeking disgorgement, civil monetary penalties, and various forms of equitable and statutory relief against Burns and McCullough.

### *C. Ponzi Schemes*

Although the Bernard Madoff saga is now years old, the fallout for hedge funds grows larger. The SEC continues to bring enforcement actions against newly uncovered Ponzi schemes while prosecuting other actions that stem from older Ponzi schemes that have ensnared additional individuals and funds. Below, we highlight three recent cases.

*1. Thomas Petters*

*Bruce F. Prévost and David W. Harrold*

Several hedge funds and fund managers have been charged with fraud in the wake of a $3.5 billion dollar Ponzi scheme perpetrated by businessman Thomas Petters. Petters was found guilty in December 2009 for masterminding the scam, and is presently serving a 50-year prison sentence.

In October 2010, the SEC charged two Florida hedge fund managers, Bruce F. Prévost and David W. Harrold, and their firms with violations of Section 17(a) of the Securities Act, Section 10(b) of the

Exchange Act and Rule 10b-5 promulgated thereunder, Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206-4(8) promulgated thereunder, for fraudulently diverting over $1 billion dollars into Petters's Ponzi scheme.[27] According to the SEC, the pair allegedly falsely assured investors that their money would be safeguarded by collateral accounts and also described to investors a non-existent process for protecting their investments. When Petters's scheme began to unravel, Prévost and Harrold concocted fake note exchange transactions with Petters in order to deceive investors. Prévost and Harrold simply exchanged old IOUs for new IOUs, all the while continuing to falsely assure investors in monthly communications that the hedge funds were continuing to make a profit on their investments.

The SEC alleges that Prévost and Harrold transferred money to Petters from 2004 to 2008, while taking in more than $58 million in fees.

*Marlon Quan*

In a case related to Petters' s Ponzi scheme, in March 2011, the SEC obtained an emergency court order halting Marlon Quan, a Connecticut-based hedge fund manager, from diverting to himself settlement funds intended for victims of the Ponzi scheme.[28] Quan, and his firms Stewardship Investment Advisors LLC and Acorn Capital Group LLC, are alleged to have funnelled money to Petters from 2001 to 2008. Quan and his funds are alleged to have violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Section 206(4) of the Advisers Act, and Rule 206-4(8) thereunder.

Quan falsely assured investors that his firms would protect their investments in his hedge funds. Instead, Quan is alleged to have concocted a series of elaborate transactions with Petters in the amount of some $187 million to disguise Petters's Ponzi scheme. As a result of these transactions, Quan was able to create the false appearance that Petters was making payments to the firms.

The SEC sought an emergency court order preventing Quan from pocketing approximately $14 million related to a receivership distribution. Quan attempted to divert the funds to banks in Germany and Bermuda for his benefit.

The SEC has also charged Quan with facilitating Petters's fraud, while taking in some $90 million in fees.

2. *Francisco Illarramendi*

Beginning in 2010, the SEC began to investigate Francisco Illarramendi, a hedge fund manager, and the hedge funds he managed. The SEC subpoenaed documents and records from Illarramendi and various hedge funds. As a result of this investigation, the SEC filed suit on January 14, 2011 against Illarramendi and two other men, Juan Carlos Zerpa and Juan Carlos Napolitano in January 2011 for alleged violations of Sections 206(1), (2) and (4) of the Advisers Act and Rule 206(4)-8 thereunder.[29]

In March 2011, the SEC, as well as the U.S. District Attorney for the District of Connecticut, revealed that Illarramendi concealed from investors the existence of millions of dollars of losses suffered in 2006 by a fund he managed.[30] From 2006 to 2011, Illarramendi created fraudulent documents, including a bogus debt instrument and a phony letter allegedly issued by a bank, as well as a concocted asset verification letter falsely stating that one of the funds had at least $275 million in credits as a result of outstanding loans, when, in fact, the fund did not have any such credits.

Illarramendi pled guilty to two counts of wire fraud, one count of securities fraud, one count of investment advisor fraud, one count each of conspiracy to obstruct justice, to obstruct an official proceeding, and to defraud the SEC. Illarramendi faces a maximum prison term of 70 years, plus fines and restitution for the full amount of losses suffered by investors and creditors.

### *D. Insider Trading*

The federal government's view of insider trading is evolving. According to SEC Associate Regional Director David Rosenfeld, what was once perceived to be generally small, single episodes of illegal behaviour has evolved into an "actual business model, where rings of sophisticated businesspeople from several distinct industries repeatedly break the law to reap huge illicit gains." Citing the Galleon Group LLC ("Galleon") case as an example, Rosenfeld stated the SEC is seeing a new trend of cases involving sophisticated conspiracies made up of corporate executives, financial consultants, and investors procuring material non-public information for the sole purpose of engaging in frequent and intentional violations of insider trading laws.[31] These schemes, according to the SEC, often involve the use of hedge funds.

In particular, the SEC and the FBI have focused their attention on alleged insider trading involving so-called "expert network" firms. Expert network firms connect industry experts with investment managers in order to research targeted industries, purportedly providing professional investment research. The industry experts, often referred to as "consultants," are typically employees who provide information and data regarding their employer. An investor or hedge fund typically pays an hourly rate, split between the networking firm and the consultant, in order to obtain information regarding the subject company's technology, revenue, and other relevant data. This can be, and often is, a legitimate research tool for investors. Nevertheless, as recent enforcement actions demonstrate, some investors and consultants may have been using such arrangements to engage in insider trading.

On March 21, 2011, Carlo V. di Florio, Director of the Office of Compliance Inspections and Examinations for the SEC, provided some insight into the SEC's position regarding expert networks and the mosaic theory of research. "Contrary to some reports that I have seen, I believe these cases do not represent some inherent hostility by the SEC toward expert networks, nor do they indicate that the SEC is seeking to undermine the mosaic theory, under which analysts and investors are free to develop market insights through assembly of information from different public and private sources, so long as that information is not material non-public information obtained in breach of or by virtue of a duty or relationship of trust and confidence."[32]

Below, we discuss the impact that mere allegations regarding insider trading can have on a hedge fund, and a recent case involving expert networking firms as alleged conduits for material, non-public information.

#### *1. Level Global Investors LP*

An example of expert networking firms and alleged insider trading intersecting with hedge funds occurred in February 2011 when Level Global Investors LP announced that the "cloud of uncertainty" created by the ongoing investigation into insider trading and a direct F.B.I. raid on the hedge fund's offices undermined its ability to operate. As of December 2010, the firm managed $4 billion in assets, with annualized returns of 9% and a cumulative return since inception of 88.9%. The hedge fund itself has not been charged with any wrongdoing, but it did employ the services of expert networking firms that were the subject of SEC investigations. Unfortunately, for some firms, even the suggestion of wrongdoing can have catastrophic results.[33]

2. *SEC v. Longoria*

In *SEC v. Longoria*,[34] the SEC alleged that Tony Longoria and several other consultants at Primary Global Research engaged in securities fraud by selling material, non-public information to hedge fund portfolio managers at New York-based hedge fund Barai Capital Management. The defendants were alleged to have violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder as well as Section 17(a) of the Securities Act.

According to the SEC's complaint, the scheme resulted in more than $30 million in illicit trades based upon the material, non-public information provided by Longoria and others about various technology companies, including Seagate Technology, Advanced Micro Devices, Western Digital, Fairchild Semiconductor, Research in Motion, and Marvell. Initially, the SEC only charged employees at the technology companies, who were moonlighting as consultants at Primary Global, for illegally tipping investment managers at hedge funds. The SEC later expanded its complaint to include traders and investment managers at Barai Capital Management and other hedge funds for buying, and trading on, the non-public information from the expert network. In a press release, the SEC stated, "[w]hile it is legal to obtain expert advice and analysis through expert networking arrangements, it is illegal to trade on material non-public information obtained in violation of a duty to keep that information confidential."[35]

### *E. Market Manipulation*

Improper trading of securities, wash sales, match orders and other manipulative market activity by hedge funds and others remains a focal point for SEC inquiries and enforcement actions. As shown below, activities that suggest market manipulation often result in action by the SEC.

*SEC v. Ficeto*

On February 24, 2011, the SEC charged two securities professionals, a hedge fund trader, and two firms involved in an alleged portfolio pumping scheme involving microcap stocks.[36] The alleged violations included Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Section 15(c)(1) of the Exchange Act, Section 17(a) of the Exchange Act and Rules 17a-4(b)(4) and 17a-8 thereunder, and violations of Sections 206(1) and 206(2) of the Advisers Act.

According to the SEC, the defendants used manipulative trading techniques to exaggerate their funds' returns and to overstate their net asset values. As a result, according to the SEC, the defendants collected tens of millions of dollars in performance fees and commissions to which they were not entitled. The defendants allegedly placed matched orders; placed orders that marked the close or otherwise set the closing price for the day; and conducted wash sales, all of which were done for the principal purpose and effect of artificially increasing the stock prices. The defendants allegedly even went so far to set up an alternative instant messaging system where they could freely discuss their illicit activities without being detected. When the investment officer abruptly resigned in 2007, the hedge funds and their investors were left with between $440 and $530 million in illiquid positions that were mostly comprised of the microcap stocks previously purchased. Among the relief sought by the SEC is permanent injunctive relief, disgorgement of illicit profits with prejudgment interest, and financial penalties.[37]

*F. Fraudulent Misrepresentations to Investors*

Hedge funds must continue to be vigilant in ensuring that any statements and representations made to investors are completely accurate. While the cases below suggest large-scale fraudulent activity on the part of the funds and their employees, even inadvertent misstatements can lead to trouble down the road.

*1. SEC v. Greenberg*

On February 10, 2011, the United States District Court for the District of Colorado entered a final judgment in the matter of SEC v. Greenberg.[38] According to the SEC, Mr. Greenberg, a principal of a broker-dealer, negligently misrepresented the safety and suitability of a number of hedge funds to investors who were in many cases in or near retirement.[39] The SEC charged that Greenberg's conduct violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Sections 206(1), 206(2), 206(4) of the Advisers Act and Rule 206(4)-8 promulgated thereunder. Greenberg touted the "immense" diversification of the funds when, for example, as of September 30, 2008, over 60% of the funds were invested in funds and partnerships associated with either Tom Petters or Bernie Madoff, individuals whose own fraudulent schemes caused massive losses in those entities. Further, the SEC alleged that Greenberg failed to adequately disclose advisory fees, failed to implement adequate compliance polices and procedures, failed to properly supervise his subordinate staff, and failed to provide accounting statements and annual reports to his clients. Among other relief, the court found Greenberg liable for disgorgement of $3,941,185, plus prejudgment interest (based on Greenberg's financial condition the court waived payment of all but $330,000 of that amount) and required Greenberg to surrender his interests in certain of the hedge funds at issue.

2. *SEC v. Kowalewski*

On January 6, 2011, the SEC filed a civil injunctive action charging Stanley J. Kowalewski and SJK Investment Management, LLC, a registered investment adviser, with violations of the federal securities laws, for defrauding investors in two hedge funds managed by SJK.[40] The violations include Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. The complaint alleges that the defendants raised $65 million for two hedge funds that were based upon the following alleged misrepresentations: (a) "substantially all" of the monies invested in the funds would be invested in "unaffiliated" underlying hedge funds pursuing complex investment strategies; (b) no single underlying fund would be allocated more than 15% of the funds' monies; (c) the funds would be responsible to pay for their "organizational" or startup expenses along with their specific operation costs; and (d) as compensation for its services, SJK would receive no more than a 1% annual asset management fee and a 10% profits incentive fee.[41] In actuality, the complaint alleges that the defendants set up a separate, undisclosed fund to which they diverted investors' monies to pay for such things as personal and vacation homes for Kowalewski, personal and business expenses, and "administration fees" that were in fact millions in salary paid to Kowalewski. The court entered an order that among other things temporarily enjoined the defendants from violations of the federal securities laws and instituted an asset freeze.

*3. SEC v. Juno Mother Earth Asset Management LLC*

In a complaint filed on March 15, 2011 in the Southern District of New York,[42] the SEC charged hedge fund advisory firm, Juno Mother Earth Management and its two founders Eugenio Verzili and Arturo

Rodriguez with defrauding clients and failing to comply with their fiduciary obligations. The SEC alleges violations by Juno, Verzili and Rodriguez of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 203A, 206(1), 206(2), 206(4) and 207 of the Advisers Act and Rules 206(4)-2, 206(4)-4 and 206(4)-8 thereunder.

The complaint alleges that Verzili and Rodriguez misappropriated approximately $1.8 million of assets from a hedge fund and then concealed their misappropriation from the fund's independent directors, inflated and misrepresented the total assets under management by approximately $40 million, filed false forms with the SEC that failed to disclose transactions between Juno and the hedge fund, concealed Juno's precarious financial condition, and misrepresented the amount of capital certain Juno partners had invested in an advised fund.

The pair allegedly used the misappropriated funds to pay Juno's payroll, rent, travel, meals and entertainment expenses. To cover up the misappropriation they allegedly caused Juno to issue promissory notes in favor of the hedge fund. The SEC's complaint seeks injunctive relief, disgorgement of any ill-gotten gains and civil monetary penalties.

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111-203, H.R. 4173) (111th Cong. 2010).

[2] Any issuer that would be an investment company as defined in section 3 of the Investment Company Act of 1940, as amended ('1940 Act') but for sections 3(c)(1) or 3(c)(7) of that act. Includes hedge funds, private equity funds, certain real estate funds, and venture funds.

[3] Under Section 956 of the Dodd-Frank Act, the term ''covered financial institution'' means (A) a depository institution or depository institution holding company, as such terms are defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813); (B) a broker-dealer registered under section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o); (C) a credit union, as described in section 19(b)(1)(A)(iv) of the Federal Reserve Act; (D) an investment advisor, as such term is defined in section 202(a)(11) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(11)); (E) the Federal National Mortgage Association; (F) the Federal Home Loan Mortgage Corporation; and (G) any other financial institution that the appropriate Federal regulators, jointly, by rule, determine should be treated as a covered financial institution for purposes of this section.

[4] The Proposed Incentive-Based Compensation Rules define "executive officer" of a covered financial institution as a person who holds the title or performs the function (regardless of title, salary or compensation) of one or more of the following positions: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, or head of a major business line.

[5] The Proposed Incentive-Based Compensation Rules define "director" of a covered financial institution as a member of the board of directors of the covered financial institution or of a board or committee performing a similar function to a board of directors. The Proposed Incentive-Based Compensation Rules also define "board of directors" as the governing body of any covered financial institution performing functions similar to a board of directors. For a foreign banking organization, "board of directors" refers to the relevant senior management or oversight body for the firm's U.S. branch, agency or operations, consistent with the foreign banking organization's overall corporate and management structure.

[6] A "covered non-public company" means any non-public company with: (i) income of at least $1 million in the last fiscal year or in two of the last three fiscal years and shareholders' equity of at least $15 million; (ii) shareholders' equity of at least $30 million and a two-year operating history; or (iii) total assets and total revenue of at least $75 million in the latest fiscal year or in two of the last three fiscal years.

[7] *Elliott Associates, L.P., et al. v. Porsche Automobil Holding SE, f/k/a Dr. Ing. h.c. F. Porsche A.G.; Wendelin Wiedeking and Holger P. Haerter, and Black Diamond Offshore, Ltd., et al. v. Porsche Automobil Holding SE, f/k/a Dr. Ing. h.c. F. Porsche AG; Wendelin Wiedeking and Holger P. Haerter,* Nos. 10 CV 0532 and 10 CV 4155 (S.D.N.Y. Dec. 30, 2010).

[8] 130 S. Ct. 2869 (2010).

[9] *Elliott Associates,* at 8.

[10] *Id.* at 12.

[11] *Id.* at 13.

[12] *S.A.C. Capital Advisors, LLC v. Biovail Corp. et al.,* No. 3:10-cv-00237-MRK (D. Conn. Feb. 17, 2010).

[13] http://dealbook.nytimes.com/2010/11/04/biovail-settles-with-sac-capital/.

[14] *Goldman Sachs Execution and Clearing, L.P. v. The Official Unsecured Creditors' Committee of Bayou Group, LLC et al.*, No. 10 civ 5622 (S.D.N.Y. Nov. 30, 2010).

[15] *Morgan Stanley & Co. Inc. v. Peak Ridge Master SPC Ltd. obo the Peak Ridge Commodities Volatility Master Fund Segregated Portfolio*, No. 10 civ 8405 (S.D.N.Y. Nov. 8, 2010).

[16] 915 N.Y.S. 2d 514 (2010).

[17] *Id.* at 518 (citations omitted).

[18] *Culross Global SPC Ltd. v. Strategic Turnaround Master Partnership Ltd.*, Privy Council Appeal No. 0045 of 2009 (Dec. 13, 2010).

[19] *Aris Multi-Strategy Lending Fund Ltd. v. Quantek Opportunity Fund, Ltd.*, Claim No. BVIHCOM2010/0129 (British Virgin Islands High Court of Justice Dec. 15, 2010).

[20] *In the Matter of Companies Law and in the Matter of Heriot African Trade Finance Fund Ltd.* (Grand Court of the Cayman Islands Jan. 4, 2011).

[21] *Id.*

[22] http://www.sec.gov/news/testimony/2011/ts031011directors.htm; *See also* Siobhan Hughes, *SEC* Looks *At Hedge Funds With Repeated, Above-Market Returns,* The Wall Street Journal, Mar. 10, 2011.

[23] SEC Litig. Release No. 21870 (Mar. 1, 2011), http://www.sec.gov/litigation/litreleases/2011/lr21870.htm.

[24] *United States v. Louis Zehil*, No. 07-CR-659 (S.D.N.Y. 2011).

[25] SEC Litig. Release No. 21811 (Jan. 13, 2011), http://www.sec.gov/litigation/litreleases/2011/lr21811.htm.

[26] *SEC v. CytoCore, Inc.*, Civil Action No. 1:11-cv-00246 (N.D. Ill. Jan. 13, 2011).

[27] *SEC v. Prévost,* Civil Action No. 10-cv-04235-PAM-SRN (D. Minn. Oct. 14, 2010).

[28] *SEC v. Quan*, No. 0:11-cv-00723 (D. Minn. Mar. 25, 2011).

[29] *SEC v. Illarramendi*, No. 3:11-cv-00078 (D. Conn. Jan. 14, 2011).

[30] Department of Justice Press Release: Connecticut Hedge Fund Adviser Admits Running Massive Ponzi Scheme; Two Others Charged in Conspiracy, Hundreds of Millions of Dollars Potentially Lost, dated Mar. 7, 2011.

[31] *See* David Rosenfeld, SEC Associate Regional Director, New York City Bar Seminar (Mar. 11, 2011).

[32] Speech by SEC Staff: Remarks at the IA Watch Annual IA Compliance Best Practices Seminar, Mar. 21, 2011.

[33] *FrontPoint Investors Seek Withdrawals*, *Financial Times,* Nov. 25, 2010. *See* http://www.ft.com/cms/s/0/266d513c-f8d7-11df-b550-00144feab49a.html#axzz1JWgEihXy.

[34] *SEC v. Longoria*, Civil Action No. 11-CV- 0753 (S.D.N.Y. Feb. 3, 2011).

[35] SEC Release No. 2011-40 (Feb. 8, 2011), http://www.sec.gov/news/press/2011/2011-40.htm.

[36] *SEC v. Ficeto*, Case No. CV-11-1637 GHK (RZx) (C.D. Cal. Feb. 24, 2011).

[37] SEC Litig. Release No. 21865 (Feb. 25, 2011), http://www.sec.gov/litigation/litreleases/2011/lr21865.htm.

[38] SEC Litig. Release No. 21852 (Feb. 11, 2011), http://www.sec.gov/litigation/litreleases/2011/lr21852.htm.

[39] *See In re: Greenberg*, Admin. Proceeding File No. 3-14033 (Sept. 7, 2010), http://www.sec.gov/litigation/admin/2010/33-9139.pdf.

[40] SEC Litig. Release No. 21800 (Jan. 7, 2011), http://www.sec.gov/litigation/litreleases/2011/lr21800.htm.

[41] *SEC v. Kowalewski*, Civil Action No. 1:11-cv-0056-TCB (N.D. Ga. Jan. 6, 2011).

[42] *SEC v. Juno Mother Earth Asset Management, LLC*, Civ. No. 11-CV 1778 (S.D.N.Y. Mar. 15, 2011).