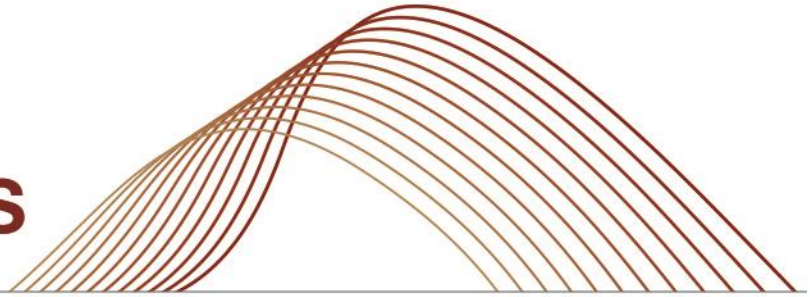
PAUL HASTINGS

PH PERSPECTIVES



August 2017

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Private Fund Report—Summary of Key Developments—Summer 2017

By the Investment Management, Private Investment Funds, Securities Litigation, Tax & Investigations and White Collar Defense Practices

This continues to be a time of rapid change for the private investment funds industry, as the Securities and Exchange Commission (the "SEC"), the Commodity Futures Trading Commission (the "CFTC"), and various other regulatory agencies, including the Department of the Treasury (the "Treasury"), continue to propose and finalize rules and issue guidance relating to private funds and fund managers. In addition, the SEC and private plaintiffs have continued to bring enforcement actions and litigation involving private funds and fund managers.

This report provides an update since our last **Report** in Winter 2016, and highlights recent regulatory developments, as well as recent civil litigation and enforcement actions as they relate to the private funds industry. Paul Hastings attorneys are available to answer your questions on these and any otherdevelopments affecting private funds and their investors and advisers.

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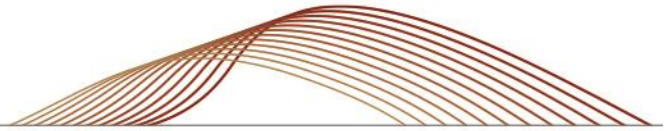


I. LEGISLATION AND REGULATIONS RELATING TO PRIVATE FUNDS AND PRIVATE FUND MANAGERS

A. Advisers Act Updates

The following items describe the status of certain proposed and final rules and regulations under the Investment Advisers Act of 1940, as amended (the "Advisers Act").

Compliance with SEC Amendments to Form ADV and Certain Rules under the Advisers Act Begins October 2017

As previously reported in our **Winter 2016 Report**, on August 25, 2016, the SEC adopted amendments to Form ADV Part 1A and certain rules promulgated under the Advisers Act (collectively, the "Amendments"), that augment the SEC's efforts to increase oversight of the investment advisory industry and modify certain disclosure requirements. The Amendments are designed to increase disclosure regarding investment advisers, including their separately managed account businesses, permit certain investment adviser entities operating as single advisory businesses to use single Form ADVs, and make other explicatory and technical amendments to the Form ADV Part 1A.

The compliance period for the Amendments starts on October 1, 2017. This means that investment advisers with a December 31st fiscal year-end must comply with the Form ADV updates by no later than their annual amendment filings due in March 2018. The SEC Release relating to the Amendments can be found **here**.

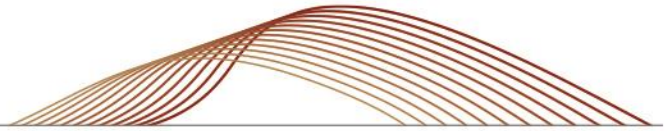
B. DOL Fiduciary Rule Update

Ongoing Uncertainty Regarding Department of Labor's Final Rules on Fiduciary Standard for Broker-Dealers

As discussed in our **Winter 2016 Report**, on April 6, 2016, the Department of Labor (the "DOL") issued a final regulation (the "Fiduciary Rule") redefining who is a "fiduciary" under the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

Some significant effects of the Fiduciary Rule are as follows:

- The DOL makes it clear in the Fiduciary Rule that the regulation applies to communications with individual retirement account ("IRA") owners, whom the DOL has sought to protect with this regulation;
- Brokers, registered investment advisers, financial planners, and other persons who advise or make recommendations to individuals or plan fiduciaries with respect to IRA money or retirement plan assets (including rollovers and distributions) and receive a fee in connection with such recommendations would be labeled fiduciaries unless an exception applies;



- Investment education will not be fiduciary advice if the materials used comply with the guidelines established in the Fiduciary Rule; provided, however, that education materials provided to IRAs, with no independent plan fiduciary, may not reference specific investment alternatives; and

- Advisers who receive compensation for making recommendations regarding retirement assets could be engaging in a prohibited transaction unless an exemption applies.

As was the case at the time of our **Winter 2016 Report**, the Fiduciary Rule remains controversial and its fate uncertain. However, on April 4, 2017, the DOL issued a final rule delaying the Fiduciary Rule's April 10, 2017 implementation date until June 9, 2017. As such, as of June 9, 2017, certain provisions, including the new definition of who qualifies as a fiduciary and the impartial conduct standards, came into effect. Brokers are now required to act under the best-interest standard of care, avoid publishing materially misleading statements, and charge compensation that is deemed reasonable. Other provisions of the Fiduciary Rule will come into effect as of January 1, 2018, including the requirement of best interest contracts and provisions that dictate the treatment of certain forms of compensation, such as 12b-1 fees. The DOL Secretary, Alexander Acosta, has stated that until January 1, 2018, the DOL will not pursue claims against fiduciaries who are working diligently and in good faith to comply with the Fiduciary Rule and related requirements, or treat those fiduciaries as being in violation of ERISA.

On June 1, 2017, the SEC announced an informal invitation for public comments on the issues addressed by the Fiduciary Rule, a move that has been interpreted by some industry observers as a potential first step towards the SEC's creation of its own fiduciary rule. In its request for comments, SEC Chair Jay Clayton remarked that the SEC was issuing its request in response to remarks by DOL Secretary Alexander Acosta that the SEC and DOL should collaborate on the analysis of the standards that should govern investment advisers and broker-dealers advising retail investors.

The SEC statement requesting public comment can be found **here**.

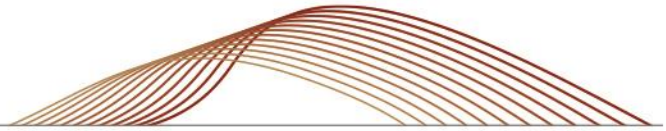
C. Other Legislative and Regulatory Updates

1. President Trump Issues Executive Order That Could Potentially Lead to Dodd-Frank Reforms

On February 3, 2017, President Trump issued an executive order (the "Order") directing a broad review of financial regulations.

The Order directs the Treasury secretary and other regulators to review existing financial regulations to determine whether they support the following seven "Core Principles:" (i) empowering Americans to make independent financial decisions; (ii) preventing taxpayer-funded bailouts; (iii) fostering economic growth through more rigorous regulatory impact analyses that address systemic risk; (iv) enabling American companies to compete with foreign competitors in domestic and foreign markets; (v) advancing American interests in international financial regulatory negotiations and meetings; (vi) making regulations efficient, effective, and appropriately tailored; and (vii) restoring public accountability within Federal financial regulatory agencies and rationalizing the Federal financial regulatory framework.

Although the Order itself does not specifically mention the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), subsequent public comments made by the Trump administration (including President Trump and Press Secretary Sean Spicer) make clear that one goal



of the review mandated by the Order is to analyze the Dodd-Frank Act to see which aspects of the law may be rolled back. For example, the Trump administration has previously stated that a top priority of these reviews is to change the mechanism of the Dodd-Frank Act that subjects banks to heightened scrutiny based on asset thresholds. The Treasury secretary and regulators were instructed to submit their respective reports by June 3, 2017, identifying any laws and regulations that inhibit regulation in a manner consistent with the "Core Principles" above. The contents of any reports submitted by the Treasury secretary and other regulators have not yet been disclosed.

2. SEC Issues Guidance on Inadvertent Custody by Fund Advisers

In February 2017 the SEC's Division of Investment Management issued a guidance update regarding circumstances whereby an investment adviser may inadvertently have custody of client funds or securities because of provisions in the custodial agreement between the advisory client and a qualified custodian. Such "inadvertent custody" is most likely to arise in the context of a separately managed account because the custodian of a separately managed account is typically hired by the client.

An adviser may be deemed to have custody of client assets under Rule 206(4)-2 under the Advisers Act (the "Custody Rule"), if, among other things, such adviser, by its instruction to the applicable custodian, is permitted to withdraw or transfer client assets from such client's account. According to the SEC, an adviser may be deemed to have inadvertent custody of a client's funds if the custody agreement between such client and its custodian can be interpreted as allowing such adviser to instruct such custodian to withdraw or transfer client assets. The SEC notes that such inadvertent custody would subject an adviser to the Custody Rule's surprise examination requirements.

The SEC's guidance provides three examples of custody agreement provisions that may lead to inadvertent custody:

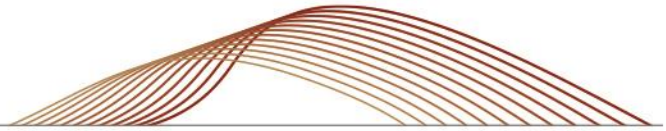
1. A custody agreement provision that gives an adviser the right to receive, and dispose of, client funds;

2. A custody agreement provision that allows a custodian to rely on an adviser's instructions, without any direction from the client; and

3. A custody agreement provision that provides authorization for an adviser to instruct the custodian to disburse client funds from a client account for any purpose.

The SEC's guidance also states that inadvertent custody may be triggered if a custody agreement grants an adviser with more access to a client's funds relative to such authority granted by such adviser's agreement with such client (e.g., if a custody agreement allows an adviser to instruct the custodian to transfer or withdraw client funds notwithstanding that such actions are prohibited by the investment advisory agreement between such adviser and client). The SEC's guidance suggests that an adviser may avoid inadvertent custody by having custodians and clients execute written consents that expressly limit such advisers' authority to "delivery versus payment," notwithstanding the terms of the custody agreement between such client and custodian. However, in practice, this solution may be administratively difficult to apply as advisers often have no visibility to custody agreements between their clients and custodians and moreover, custodians may not agree to provide such written consent.

The text of the SEC guidance update can be found **here**.



3. SEC Releases Its 2017 Examination Priorities

On January 12, 2017, the SEC published the Office of Compliance Inspections and Examinations' ("OCIE") examination priorities for 2017. According to the publication, the SEC's new focuses will include electronic investment advice (so called "robo-advisers"), money market funds, and the protection of senior investors. The publication also emphasizes the SEC's continued focus on the protection of retail investors and the assessment of market-wide risks.

With respect to retail investors, OCIE will examine firms delivering investment advice via electronic mechanisms, as well as wrap-fee programs in which investors are charged a single bundled fee for advisory and brokerage services. With respect to senior investors and retirement investors, OCIE will continue to focus on public pension advisers and will expand its focus on senior investors and individuals investing for retirement. According to the publication, OCIE will broaden its ReTIRE initiative to include review of advisers and broker-dealers that offer variable insurance products to investors with retirement accounts, and advisers that offer and manage target-date funds. The ReTIRE initiative is comprised of risk-based examinations that focus on, among other things, whether advisers have a reasonable basis for the recommendations they make to their retirement account clients, and whether advisers actively police their marketing materials to ensure that they are not misleading.

According to the publication, OCIE will continue to focus on registrants' compliance with the SEC's Regulation SCI and anti-money laundering rules. New initiatives for 2017 include an evaluation of money market funds' compliance with the SEC's amended rules (which became effective on October 2016). Also according to the publication, OCIE will continue conducting inspections of the Financial Industry Regulatory Authority, Inc.'s ("FINRA") operations and regulatory programs, and will focus on assessing examinations of individual broker-dealers. OCIE will also continue to examine cybersecurity compliance procedures and policies, including the implementation thereof by advisers and broker dealers.

4. FINRA Publishes Its 2017 Examination Priorities

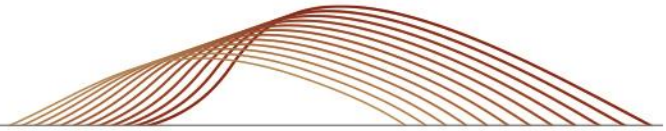
On January 4, 2017, FINRA published its Annual Regulatory and Examination Priorities Letter (the "FINRA Priorities Letter") highlighting issues of importance to FINRA's regulatory programs.

In 2017, FINRA plans to focus on, among other things:

1. *High-risk and recidivist brokers.* According to the FINRA Priorities Letter, FINRA will devote particular attention to the hiring and monitoring of high-risk and recidivist brokers by firms, including by evaluating the measures taken by firms to establish appropriate supervisory and compliance controls for such persons. FINRA plans to bolster its approach to high-risk and recidivist brokers by (i) deploying a recently established examination unit to identify and examine brokers that pose a high risk to investors by reviewing such brokers' interactions with customers, (ii) reviewing firms' due diligence procedures when hiring such persons to assess whether such firms have effective supervisory plans tailored to detect and prevent misconduct, and (iii) continuing to evaluate firms' branch office inspection programs.

2. *Sales Practices*.

   a) *Product suitability and concentration*. FINRA plans to focus on the recommendation practices of firms to assess how they conduct reasonable basis and customer-specific



suitability reviews, including examining firms' product vetting processes, supervisory systems, and controls to review recommendations.

b) *Excessive and short-term trading of long-term products.* According to the FINRA Priorities Letter, FINRA has observed instances whereby firms recommend that their clients trade long-term products—such as open-end mutual funds and variable annuities—on a short-term basis, which is detrimental to clients who may suffer diminished returns due to increased costs. In light of this, FINRA plans to evaluate firms' abilities to monitor for short-term trading of long term products.

c) *Senior Investors.* FINRA will assess firms' controls to protect senior investors from fraud, abuse, and improper advice. FINRA will also focus on microcap fraud schemes that target the elderly.

d) *Social Media and Electronic Communications Retention and Supervision.* According to the FINRA Priorities Letter, FINRA will review firms' compliance with their supervisory and record-retention obligations with respect to social media and other electronic communications.

e) *Outside Business Activities and Private Securities Transactions.* FINRA plans to focus on firms' obligations regarding the outside business activities and private securities transactions of their registered representatives. The focus will be on the adequacy of firms' procedures to review written notifications of proposed outside activities by registered persons, as well as firms' procedures for handling associated persons' notifications of proposed private securities transactions, and firms' ongoing supervision of such persons' approved private securities transactions.

3. Financial Risks.

a) *Liquidity risk.* Following the results of an assessment in 2016 of funds' liquidity management practices that revealed various deficiencies including the lack of liquidity risk management plans, the lack of stress testing, and the maintenance of insufficient sources of funding, FINRA plans to review firms' funding and liquidity plans, and assess whether such firms adequately evaluate their liquidity needs in relation to market-wide stresses, develop contingency plans to ensure sufficient liquidity in the face of such stresses, and conduct stress tests and other reviews to assess the sufficiency of their contingency plans.

b) *Financial Risk Management.* FINRA plans to work with firms to assess their market, credit, and liquidity risks. In relation to this, FINRA will assess the firms' risk management practices, including readiness, communication plans, risk metrics and triggers, and contingencies.

c) *Credit Risk Policies, Procedures and Risk Limit Determinations Under FINRA Rule 4210.* In 2017, FINRA will assess firms' implementation of the obligations created by the amendments to FINRA Rule 4210, which were approved by the SEC in June 2016. FINRA will review firms' written risk policies, procedures, risk limit setting processes, and the manner in which firms establish and supervise for compliance with the rule's requirements.

4. Operational Risks.

a) *Cybersecurity*. FINRA will continue to focus on firms' efforts to mitigate cybersecurity risks. According to the FINRA Priorities Letter, FINRA recognizes that there is no one-size fits all solution to cybersecurity threats, such that FINRA plans to evaluate each firm based on a number of factors, including business model, size, and risk profile. FINRA examinations will likely review firms' methods to prevent data loss and controls used to monitor and protect client data, which controls should be informed by a number of factors, including a clear understanding of any customer or employee personally identifiable information or sensitive firm information to which vendors have access.

b) *Supervisory Controls Testing*. FINRA will review firms' testing of their internal supervisory controls to determine their ability to, among other things, identify and mitigate inadequate controls such as poorly set parameters in automated control systems.

c) *Customer Protection/Segregation of Client Assets*. FINRA will seek to determine whether firms are complying with the requirements of SEA Rule 15c3-3, which requires that firms implement and adopt adequate controls and supervision to protect customer assets.

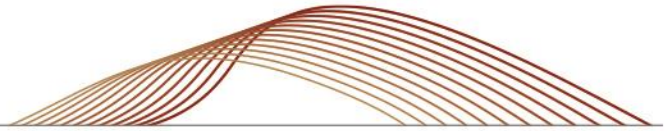
d) *Regulation SHO — Close Out and Easy to Borrow.* FINRA plans to focus on the locate process, pursuant to SEC Regulation SHO, to ensure that firms have a reasonable basis to believe that securities are available to borrow before accepting a short sale. FINRA will assess the use of the easy-to-borrow list by firms and evaluate the adequacy of firms' automated locate models.

e) *Anti-Money Laundering and Suspicious Activity Monitoring*. According to the FINRA Priorities Letter, FINRA will continue to focus on firms' anti-money laundering programs, especially firms that FINRA has previously identified as exhibiting shortcomings, including firms with gaps in their automated trading and money movement surveillance systems caused by data integrity problems.

f) *Municipal Adviser Registration.* According to the FINRA Priorities Letter, FINRA has observed that some firms are not properly registering or updating their existing registrations with both the SEC and Municipal Securities Rulemaking Board. In addition, FINRA has found that some firms are not properly registering their municipal advisory personnel as required on SEC Form MA-I. As such, FINRA plans to pay particular attention to this area.

5. Market Integrity.

a) *Manipulation.* Detecting and deterring market manipulation remains a critical area of focus for FINRA. FINRA's efforts in this area include the amendment of its Order Audit Trail System (OATS) rules to require alternative trading systems to submit broader order book activity to OATS and to require FINRA members to capture in their OATS reports the identity of non-FINRA member broker-dealers participating in the over-the-counter market.



b) *Best Execution*. FINRA will assess firms' compliance with their best execution obligations to their clients as previously discussed in FINRA's November 2015 Regulatory Notice 15-46.

c) *Audit Trail Reporting Early Remediation Initiative and Expansion.* FINRA plans to expand its Audit Trail Reporting Early Remediation Initiative, which identifies and alerts firms of potential equity audit trail issues, to other areas, including Regulation NMS trade-throughs and locked and crossed markets.

d) *Tick Size Pilot.* According to the FINRA Priorities Letter, Tick Size Pilot's data collection obligations will continue throughout 2017 and FINRA will review firms' compliance with such data collection requirements, and with its quoting and trading restrictions.

e) *Market Access Rule.* FINRA has identified the need for firms' continued compliance with the Market Access Rule. FINRA counsels that firms employ best practices for compliance with their obligations under the Market Access Rule, including implementing, memorializing and monitoring pre-trade and post-trade controls.

f) *Trading Examinations.* Among FINRA's 2017 examination priorities is the review of the adequacy of alternative trading systems' disclosures to customers about how they operate. In this regard, FINRA will launch a pilot trading examination program that will help it determine the value of conducting targeted examinations of smaller firms that have historically not been subject to trading examinations due to their low trading volume.

g) *Fixed Income Securities Surveillance Program.* FINRA plans to continue to enhance its fixed income surveillance programs and to conduct investigations into problematic activity it detects through its surveillance program. FINRA also plans to develop customer protection surveillance patterns focusing on compliance with rules applicable to U.S. Treasury securities, as well as patterns looking for abusive algorithms.

The text of the FINRA release can be found **here**.

5. *California Law Requiring Increased Disclosure of Fees and Expenses for Certain Private Funds Becomes Effective*

As discussed in our **Winter 2016 Report**, on September 14, 2016, California Governor Jerry Brown signed into law a bill requiring private funds in which California public pension plans and retirement systems (such private funds, the "Subject Funds" and such public pension plans and retirement systems collectively, "California Retirement Plans") have invested to make certain annual, public disclosures regarding certain of such Subject Funds' fees and expenses with respect to California Retirement Plans (the "CA Fee Disclosure Law").

The CA Fee Disclosure Law went into effect on January 1, 2017 such that the CA Fee Disclosure Law applies to all new contracts (e.g., subscription agreements) entered into by a California Retirement Plan and a Subject Fund on or after January 1, 2017, and to all existing contracts pursuant to which a California Retirement Plan makes a new capital commitment on or after January 1, 2017. Furthermore, California Retirement Plans will also be required to "undertake reasonable efforts" to obtain the information required by the CA Fee Disclosure Law for any contracts entered into by a

California Retirement Plan with a Subject Fund prior to January 1, 2017, even if such California Retirement Plan has not made a new capital commitment to such Subject Fund on or after January 1, 2017.

The text of the bill can be found **here**.

D. CFTC and NFA Updates

1. NFA Publishes Notice on CFTC Amendments to Regulations Regarding CPO Financial Reports

On February 23, 2017, the National Futures Association ("NFA") published guidance on how commodity pool operators ("CPOs") can file notices with the NFA that are required for CPOs to avail themselves of relief provided under the CFTC's amendments to its Part 4 regulations relating to CPOs and their financial reporting obligations. In short, the amendments permit the use of specified alternative generally accepted accounting principles standards or practices ("Additional Alternative GAAP"), and provide relief from the annual report audit requirement under certain circumstances. We covered the amendments to the Part 4 regulations in our **Winter 2016 Report**.

Some of the items covered by the notice are as follows:

1. *Notifying the NFA of the Use of Additional Alternative GAAP*. CFTC regulations now permit non-U.S. pools to use Additional Alternative GAAP in the computation and presentation of annual reports, periodic account statements, and/or pool quarterly reports. To claim Additional Alternative GAAP relief under CFTC Regulation 4.22, a CPO must file the 4.22(d)(2) pool exemption with the NFA within 90 calendar days after the end of the pool's first fiscal year.

2. *Notifying the NFA of Annual Report Audit Requirement Relief Due to Stub Period.* CFTC regulations now permit a CPO to provide unaudited annual reports for a pool's first fiscal year, provided that the following conditions are satisfied:

   a) The period between when the CPO first receives funds from a participant and the pool's first fiscal year end is 4 months or less (the "Stub Period");

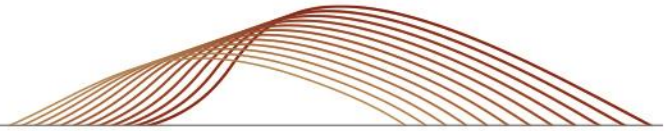
   b) Throughout the Stub Period, the pool had no more than 15 participants with gross capital contributions to the pool of $3 million or less, excluding certain participants;

   c) Each participant waives its right to receive an audited annual report for the pool's first fiscal year end;

   d) A notice is filed with the NFA prior to the date the CPO is required to distribute and submit the annual report for the pool's first fiscal year end; and

   e) The next annual report for the pool is audited and includes the Stub Period plus the pool's first 12-month fiscal year.

3. *Notifying the NFA of Annual Report Audit Requirement Relief Due to Pool Participants Only Being Insiders*. CFTC regulations now permit a CPO to provide an unaudited annual report if, during any fiscal year, the pool only had insiders as participants. To claim this relief, the CPO must obtain a written waiver from each insider pool participant of their right to



receive an audited annual report. To notify the NFA that the CPO is relying on this relief, the CPO must check box 5018 when filing the pool's annual report with the NFA.

4. *Enhancement to the NFA's EasyFile Extensions and Notice Filing System*. The NFA enhanced its EasyFile Extensions and Notice Filing system to allow CPOs to include multiple pools when filing a single notice. The system can be used to file certain notices under CFTC Regulation sections 1.16 and 4.22.

   Although each of the above notices can be filed on behalf of multiple pools, CPOs can only select one rule reference for each notice. Also, CPOs can only file once for each ending date.

The text of the NFA notice can be found **here**.

2. CFTC Adopts Amended Position Limit Aggregation Rules

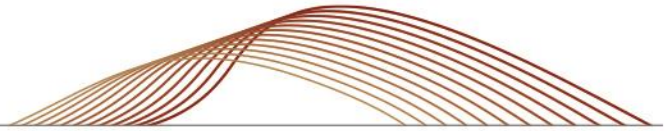
On December 16, 2016, the CFTC adopted a final rule amending part 150 of its regulations regarding aggregation under the CFTC's position limits regime for futures and option contracts. CFTC aggregation rules generally require that a person aggregate all positions in accounts or funds that the person directly or indirectly controls trading or holds a 10% or greater ownership interest, including the positions of any other person with whom the person trades pursuant to an express or implied agreement. The amended rules, which apply to all market participants regardless of their registration status, do not change the current standard for when aggregation is required. Instead, they clarify the scope of existing aggregation requirements and exemptions and adopt new exemptions.

1. *Aggregation of Substantially Identical Trading Strategies.* Under the amended rules, a person must aggregate, on a pro rata basis, all account or fund positions that it owns or controls, regardless of the level of ownership in such account or fund positions, having substantially identical trading strategies with all positions held or controlled by such person and that the person is otherwise required to aggregate. The CFTC is yet to define what constitutes "substantially identical" trading strategies.

2. *Exemptions from Aggregation.*

   a) *Owned Entity Exemption*. Under the amended rules, a person that would otherwise be required to aggregate the positions of separate entities because it owns a 10% or greater ownership interest in such entities (each an "owned entity"), can avoid aggregation if the owned entity (A) does not have knowledge of the trading decisions of the other entity, (B) trades pursuant to separately developed and independent trading systems, (C) has and enforces written procedures to preclude itself from having knowledge of, gaining access to, or receiving data about, the trades of the other entity, (D) does not share employees that control trading decisions of the other entity, and (E) does not have risk management systems that permit the sharing of trades or trading strategy with employees that control the trading decisions of the other entity. Persons seeking to rely on this exemption were required to make a notice filing with the CFTC by February 14, 2017.

   b) *Independent Account Controller.* The amended rules provide that aggregation is not required for accounts of an eligible entity managed by an independent account controller (except for the spot month in physical delivery contracts), provided that such independent account controller does not exceed the federal limits and certain other



conditions are met. The amended rules expand the definition of "eligible entity" to include any person with a role equivalent to a general partner in a limited liability partnership or a managing member of a limited liability company. Notably, this exemption only covers the entity's client positions or accounts and does not extend to proprietary accounts. Persons seeking to rely on this exemption were required to make a notice filing with the CFTC by February 14, 2017.

c) *Information Sharing.* Under the amended rules there is an exemption from aggregation for an owned entity's accounts or positions in circumstances where sharing the information associated with aggregation would create a reasonable risk of violation of applicable federal, state, or foreign laws or regulations. Persons seeking to rely on this exemption were required to make a notice filing with the CFTC by February 14, 2017.

d) *Underwriting.* Under the amended rules, the positions and accounts of an owned entity are exempt from aggregation if the person's ownership interest is based on the ownership of securities constituting all or a portion of an unsold allotment to or subscription by the person as a participant in the distribution of securities by the issuer or by or through an underwriter. This exemption is self-executing.

e) *Broker-Dealers.* Broker-dealers registered with the SEC or with an equivalent non-U.S. regulatory authority are not required to aggregate their positions or accounts with the positions or accounts of an owned entity if the securities are acquired in the ordinary course of business as a dealer, as long as the person does not have actual knowledge of the trading decisions of the owned entity. This exemption is self-executing.

f) *Fund Investors.* Under the amended rules, a fund investor that directly or directly has a 10% or greater ownership interest in a fund is exempt from aggregating the positions of the fund with any other accounts or positions that such person is required to aggregate. This exemption is not available to the CPO of a fund and is not available to a person that directly or indirectly has a 25% or greater ownership interest in a fund whose operator is exempt from registration under CFTC Rule 4.13(a)(3). However, an individual that is a principal of a fund or an affiliate of the CPO, and meets or exceeds the 10% threshold, must aggregate its positions of the fund unless it satisfies certain criteria and makes a notice filing. Persons required to make a notice filing to rely on this exemption were required to make a notice filing with the CFTC by February 14, 2017.

g) *Accounts Held by Futures Commission Merchants.* Generally, futures commission merchants are not required to aggregate positions held in discretionary accounts or in accounts that are part of a futures commission merchant's customer trading program if certain requirements are met. The amended rules now require future commission merchants to make notice filings. Futures commission merchants seeking to rely on this exemption were required to make a notice filing with the CFTC by February 14, 2017.

3. *Notice Filing Requirement*. As noted above, many of the exemptions from aggregation under the amended rules require a notice filing with the CFTC. Such filing, which is effective upon submission, must include a description of the relevant circumstances that warrant exemption from aggregation and the statement of a senior officer of the entity certifying that the conditions of the exemption have been met. Filers must make prompt

amendment filings in the event of changes to the information provided in a previous filing. Failure to file a timely notice will not constitute a violation of a position limit if the notice filing is made within five business days of the date on which the person becomes aware, or should be aware, that a notice filing was not filed.

The text of the final rule can be found **here**.

E. Cayman Islands Updates[1]

1. Cayman Islands' Beneficial Ownership Law to Take Effect on July 1, 2017

Three new pieces of legislation amending the Companies Law (2016 Revision) (the "Companies Law"), the Limited Liability Companies Law, 2016, and the Companies Management Law (2003 Revision) (collectively, the "Laws") came into force in the Cayman Islands on July 1, 2017. The Laws will require certain companies incorporated or registered in the Cayman Islands to maintain a register of information about their beneficial owners (a "Register"). Such companies will be required to engage either their corporate services providers or the Registrar of Companies to establish and maintain the Register. The information contained in such Register will be automatically accessible to the Cayman Islands Minister with responsibility for financial services through a centralized electronic beneficial ownership platform, but will otherwise be private.

Are your Cayman Islands vehicles required to establish a beneficial ownership register?

The new requirement to maintain a Register will apply to companies incorporated in the Cayman Islands, with certain exceptions, as summarized below. Cayman Islands partnerships, including exempted limited partnerships, will not be required to maintain a Register under the Laws.

Cayman Islands companies that will not have to maintain a Register under the new regime include companies that are:

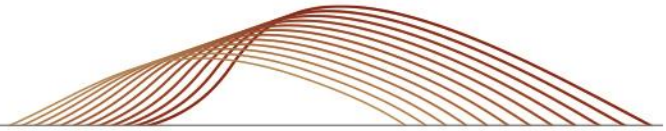
1. listed on the Cayman Islands Stock Exchange or an approved stock exchange under the Companies Law;

2. registered or licensed under a "regulatory law", including the Mutual Funds Law (2015 Revision) (the "Mutual Funds Law"), the Securities Investment Business Law (2015 Revision), and the Insurance Law, 2010;

3. special purpose vehicles, private equity or collective investment schemes or investment funds which are managed, arranged, administered, operated, or promoted by a person (or a subsidiary of a person) who is regulated or listed in the Cayman Islands or an approved jurisdiction (an "approved person"); and

4. general partner(s) of a special purpose vehicle, private equity or collective investment scheme or investment fund that is managed, arranged, administered, operated, or promoted by an approved person.

It is expected that the majority of private funds structured as Cayman Islands companies will not be required to maintain a Register under the new regime on the basis that they are registered under the Mutual Funds Law or managed, arranged, administered, operated, or promoted by an approved person (or both). However, there are cases of private funds structured as Cayman Islands companies



that do not fall within the exceptions described above and that will be subject to the new regime. Each case will need to be analyzed on its facts.

Timing

A one-year transitional period commenced on July 1, 2017, the date on which the Laws came into force. During this period, companies will not be prosecuted for failing to establish or maintain a Register.

2. Update Regarding Automatic Exchange of Information

Common Reporting Standard

At the end of 2016, the Cayman Islands Government adopted new regulations amending The Tax Information Authority (International Tax Compliance) (Common Reporting Standard) Regulations, 2015 (the "Amended Regulations"). The Amended Regulations ensure the effective implementation of the Common Reporting Standard ("CRS") in the Cayman Islands.

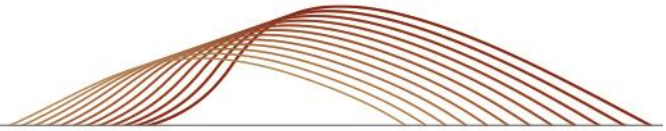
1. *Notification requirement*. The Amended Regulations now provide that all *Cayman Financial Institutions*[2] ("CFIs"), including *Non-Reporting Financial Institutions*, must file an information notice with the Cayman Islands Tax Information Authority ("TIA"), the deadline for which was extended to June 30, 2017 or, if an entity becomes a CFI after that date, then on or before April 30 of the following year. The information notice must provide certain *required information*, including the name and CRS classification of the entity, together with comprehensive details of the person authorized to be that entity's principal point of contact for CRS purposes. Any changes to the *required information* must be notified to the TIA and all notifications must be completed electronically.

2. *Return and nil return requirement*. All *Cayman Reporting Financial Institutions* ("CRFI") must file an annual return with the TIA by May 31 of each year relating to the entity's *Reportable Accounts* (for 2017 only, the deadline has been extended to July 31, 2017). In addition, the Amended Regulations now require the mandatory filing of nil returns, where a CRFI did not maintain any *Reportable Account* in any *Reportable Jurisdiction* during the relevant year.

3. *Written policies and procedures*. The policies and procedures required to be established in order to identify *Reportable Accounts* must now be in writing. Such policies and procedures must be implemented by each CRFI and complied with.

4. *Offences. The Amended* Regulations now include various offences and corresponding defenses. The offences include making false self-certifications, intentionally providing inaccurate information, tampering with (altering, destroying, mutilating, defacing, hiding, or removing) information, or hindering the TIA from performing its functions concerning CRS. Where a CFI has committed an offence, the Amended Regulations also provide for the imputed criminal liability of the directors, managers, secretaries, trustees, general partner, and other similar officers of that CFI.

5. *Penalties*. Fines may be imposed where a person has been found guilty of an offence under the Amended Regulations. The Amended Regulations also provide for the imposition of continuing penalties by the TIA, including where a contravention has not been remedied



or a fine relating to an offence has not been paid. The financial penalties under the Amended Regulations are harsher than those under the U.S. Foreign Account Tax Compliance Act ("U.S. FATCA"), with fines of up to US$60,975 for an offence by a body corporate, with the possibility of additional continuing penalties and interest thereon. The Amended Regulations also provide the criteria to be considered by the TIA in imposing any penalty, limitation periods, and an appeals procedure.

6. *Guidance*. The Cayman Islands Department of International Tax Co-operation (the "DITC") has published revised CRS Guidance Notes.

U.S. FATCA

The notification and reporting deadlines for U.S. FATCA were extended to June 30, 2017 and July 31, 2017, respectively.

U.K. CDOT

The DITC has confirmed that CRFIs will not have notification or reporting obligations regarding U.K. CDOT this year and onwards because those obligations are superseded by the corresponding obligations under CRS.

European Union Savings Directive

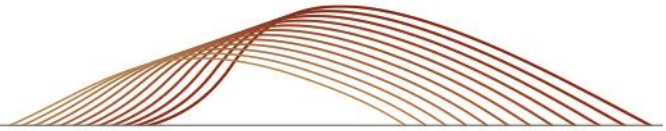
The DITC has confirmed that reporting of savings income information for European Union Savings Directive purposes is not required from this year and onwards because this information will be covered by reporting under the CRS.

3. *Reinstatement of a Company to the Register of Companies — In the Matter of OVS Capital Management (Cayman) Limited*

A petition was made under the Companies Law to re-instate OVS Capital Management (Cayman) Limited to the Register of Companies after it was struck off for failing to file annual returns. Under the Companies Law a company may be reinstated to the Register of Companies if the court is satisfied that the company was, at the time of strike-off, carrying on business or in operation, or otherwise that it is just that the company be restored. The court determined that the fact the company was in the process of distributing assets to its shareholders was sufficient to constitute the company being 'in operation' and that it was just in the circumstances to restore the company to the Register of Companies in order to allow the voluntary liquidator to continue to realize the assets of the company and distribute them to the company's shareholders.

4. *Enforcement of Foreign Judgment — Midtown Acquisitions l.P. v. Essar Global Fund Limited*

The plaintiff in this matter applied for summary judgment to enforce a judgment of the New York Supreme Court. The judgment awarded sums to various creditors arising from default on a large loan. The court accepted that a foreign money judgment is enforceable in the Cayman Islands if it is: (a) made by a court of competent jurisdiction; (b) of a debt or definite sum of money; (c) final and conclusive; and (d) not impeachable on the basis of fraud or contrary to public policy or natural justice. In particular, the court determined that to establish fraud in relation to a foreign judgment, there must be more than mere negligence or inadvertence and the relevant act of conscious or deliberate dishonesty must be 'material' in that if the claim were to be retried on honest evidence, the court would have approached or come to a decision in an entirely different way. In this



instance, the court found that there were no triable issues of foreign law before it, and that the New York judgment was analogous to a default judgment and therefore, unless substantively altered, it was final and conclusive. The application was ultimately refused on the grounds that the defendant had satisfied the court that there were issues to be tried. Further, because certain key evidence was not placed before the New York Court and the defendant did not have advance notice of the application to the New York Court, the court determined that the defendant had a real prospect of succeeding on a defence that the New York judgment was obtained by fraud, misrepresentation or other misconduct, that the enforcement would be contrary to public policy, and that the judgment was obtained in breach of the principles of natural justice.

II. CIVIL LITIGATION

Litigation matters involving private funds continue to involve interesting and novel issues. Significant recent developments include the following:

1. a California judge certified a class of shareholders in the ongoing dispute over Pershing Square and Valeant Pharmaceuticals' failed takeover of Allergan, Inc. ("Allergan");

2. the Patent Trial and Appeal Board has rejected several requests for *inter partes* review by entities connected to Kyle Bass' short strategy;

3. a New York appellate court has affirmed a $22 million judgment against Deutsche Bank for breach of credit default swap contracts in favor of plaintiff hedge funds;

4. healthcare startup Theranos has settled suits by plaintiff hedge fund investors;

5. a New York trial court has allowed breach of contract claims by a hedge fund to proceed against its administrator for allegedly transferring funds to Chinese hackers;

6. accounting firm Ernst & Young has disclosed the settlement of a suit by the liquidators of the hedge fund Weavering Macro;

7. hedge fund holders of Puerto Rican bonds have filed suit against the commonwealth after a stay implemented by federal law ended; and

8. RD Legal has filed a civil suit for injunction against an investigation by the Consumer Financial Protection Bureau.

A. Update on Previously Reported Cases

1. California Court Certifies Class Action in Ongoing Allergan Shareholder Suit

In our **Spring 2016 Report**, we first reported that claims by shareholders of Allergan, against Pershing Square Funds and Valeant Pharmaceuticals had survived a motion to dismiss. Plaintiff shareholders, including two public retirement funds, claimed that Valeant had tipped off Pershing about its undisclosed plans to acquire Allergan.[3] According to plaintiffs, Pershing then acquired a 10 percent stake in Allergan.[4] The plaintiffs alleged that Pershing sold its shares at a profit and provided a kickback to Valeant when Valeant announced its takeover plans.[5] The U.S. District Court for the Central District of California rejected defendants' motion to dismiss, reasoning that the plaintiffs had "adequately alleged that Valeant knew that its tip would be traded on."[6] In our **Winter 2016 Report**, we reported that the court had upheld a subpoena for documents from third party Allergan that had been obtained in its own (now settled[7]) suit against Pershing and Valeant. The court

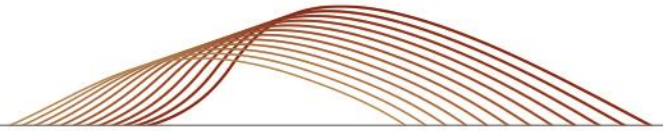
ruled that, although the test under SEC Rule 14e-3 is objective, Allergan's internal analysis of tender offers was relevant to the reasonableness of defendants' actions.[8] The court stated that the fact Allergan had been considering *other* offers "would lend credence to Defendants' argument that they were proposing a merger to Allergan, rather than attempting a takeover."[9]

On March 15, 2017, the court granted class certification to the plaintiff shareholders of Allergan.[10] The ruling focused on the question of typicality, which requires that the named plaintiffs' claims be "reasonably co-extensive with those of absent class members," although "they need not be substantially identical."[11] The defendants contended that the named plaintiffs who had held stock at the time of Valeant's takeover announcement did not suffer injuries typical of class members who later purchased the stock.[12] In certifying the class, the court noted that "courts have declined to reach the issue of whether plaintiffs should be excluded from the class on the grounds that a plaintiff was a net 'winner' at the class certification stage."[13] Further, the court ruled that the named plaintiffs raised the same "core" allegations that would be central to the class's claims—namely, they alleged that the defendants improperly traded on material nonpublic information.[14] Consequently, the court found that, although the named plaintiffs "may have made money as a result of the merger[,] [that] does not subject them to [a] unique defense in relation to their insider trading claims such that they are rendered atypical."[15]

2. Patent Trial and Appeal Board Rejects Inter Partes Claims in Kyle Bass' Short Strategy

In our **Fall 2015 Report** and **Spring 2016 Report**, we reported on Kyle Bass' use of *inter partes* review ("IPR") under the America Invents Act as part of the investment strategy of Bass' fund, Hayman Capital Management LP ("Hayman Capital"). Neither Hayman Capital nor related entities such as the Coalition for Affordable Drugs (the "Coalition") are direct competitors with the pharmaceutical companies who owned the challenged patents. Although Hayman Capital's strategy is not clear, Bass has indicated that it is a component of his "short activist strategy."[16] In our **Winter 2016 Report**, we noted that members of New York State's delegation to the U.S. House of Representatives had weighed in on Bass' practices. In a December 5, 2016 letter to the U.S. Patent and Trademark Office (the "USPTO"), the New York representatives wrote, "[W]e are concerned with numerous recent attempts by hedge funds to short the stocks of targeted companies prior to IPR filing. We are also concerned that hedge funds are filing repeat petitions challenging certain patents, even though previous IPR petitions on these patents had already been rejected by the U.S. Patent & Trademark Office (PTO)."[17] The representatives urged the USPTO to take action, writing: "[U]nder 35 U.S.C. 314(a), the PTO has general discretion to deny institution of petitions in cases where institution would not be in the interests of justice."[18]

Since the New York representatives' letter, the Patent Trial and Appeal Board ("PTAB") has affirmed the validity of a number of patents that have been challenged by entities affiliated with Bass as part of his alleged short strategy. On February 21, 2017, PTAB upheld the validity of a patent on the arthritis and ulcer drug Vimovo after an IPR challenge by the Coalition for Affordable Drugs.[19] The Coalition had challenged the patent on the grounds of obviousness, but the PTAB ruled that the "unexpected" effectiveness of the drug rebutted the challenge.[20] Similarly, on March 21, 2017, PTAB again rejected a claim of obviousness by the Coalition, this time against a drug targeting multiple sclerosis.[21] PTAB ruled that the Coalition had failed to rebut evidence indicating that the effectiveness of a particular dosage was not obvious in light of prior art.[22] A report released by nXn Partners LLC—an analytics company led by Bass' colleague, Erich Spangenberg—found that only nine of the Coalition's 34 petitions resulted in the invalidity of at least some of the challenged claims.[23] Although the report did not detail the financial results of Bass' "short strategy," some commentators observed that the



market had become less responsive to Bass' challenges. Gerald Flattmann, a Paul Hastings partner who defended several of the challenges, said that, after an initial decline in the market, the early defeats Bass suffered meant that "Wall Street was less willing to engage in a knee-jerk reaction in terms of stock price and pharma was less alarmed than it was."[24] Flattmann and his team defeated all nine of the IPR challenges filed by Bass against Paul Hastings' clients.

3. $22 Million Judgment Against Deutsche Bank Affirmed

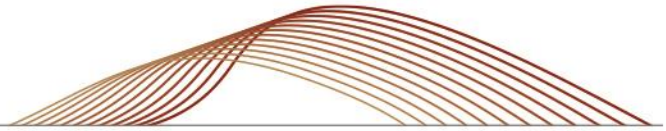
In our **Spring 2016 Report**, we reported that hedge funds Good Hill Master Fund LP and Good Hill Master Fund II LLP (collectively, "Good Hill") won a $22 million judgment against Deutsche Bank in New York state court. Good Hill had asserted claims for breach of contract of credit default swap agreements and sought the return of collateral the hedge funds posted to Deutsche Bank.[25] Deutsche Bank refused to return the collateral, arguing that Good Hill acted in bad faith and in a commercially unreasonable manner when Good Hill sold the notes at a higher than justified price at Deutsche Bank's expense.[26] The trial court found that under the swap agreements, Good Hill was "free to negotiate a favorably-priced sale" and that the mere fact that the sale was "advantageous to Good Hill and disadvantageous to Deutsche Bank" was "hardly sufficient to establish bad faith."[27] In our **Winter 2016 Report**, we reported that Deutsche Bank had appealed the trial court's ruling,[28] arguing that the trial court's ruling was erroneous.[29]

On January 24, 2017, the appellate court affirmed the lower court's ruling.[30] The court held that "contrary to Deutsche Bank's contentions, in negotiating this allocation, however aggressively, Good Hill acted in good faith and in a commercially reasonable manner, and Deutsche Bank failed to meet its burden of proving that Good Hill breached implied covenants of good faith and fair dealing."[31] One section of the agreement allowed the parties to "act with respect to such business in the same manner as each of them would if" the credit swap agreement did not exist.[32] The appellate court affirmed that the trial court had correctly construed this as allowing each party to "pursue its own interests, even if it might have an adverse effect on" the other party.[33]

4. Healthcare Start-Up Theranos and Hedge Funds Settle Investor Suit

In our **Winter 2016 Report**, we reported that hedge funds Partner Investments, L.P., PFM Healthcare Master Fund, L.P., and PFM Healthcare Principals Fund, L.P. (collectively, "PFM") filed a complaint in Delaware Chancery Court on October 10, 2016, alleging that Theranos, Inc. ("Theranos"), its Chief Executive Officer, Elizabeth Holmes, and its former Chief Operating Officer, Ramesh Balwani, defrauded investors. PFM invested approximately $96.1 million in Theranos, a privately held consumer healthcare technology company.[34] In fall 2013, Theranos became known for its blood testing technology, which promised results in only a few hours "with as little as a few drops of blood."[35] In October 2015, the *Wall Street Journal* published an investigative report showing that Theranos struggled with its blood-test technology and, in fact, only used its proprietary technology for a small number of tests, some of which had questionable results.[36] The United States Department of Justice and the SEC launched investigations into Theranos, and the Centers for Medicare and Medicaid Services ("CMS") revoked the Company's license to operate a lab in California and banned Holmes from operating a lab for at least two years.[37]

In our **Winter 2016 Report**, we reported that on November 23, 2016, Theranos, Holmes, and Balwani moved to dismiss certain counts of PFM's complaint, arguing that those counts "invoke[d] . . . alleged misrepresentations that post-date PFM's investment [and] have no place in this case."[38]



On May 1, 2017, the parties reached a settlement for an undisclosed sum.[39] The settlement required PFM to dismiss all claims against Theranos with prejudice and allowed Theranos to go forward with a tender offer with its largest investors.[40] In a statement, Theranos stated, "Although we are confident that we would have prevailed at trial, resolution of these two cases . . . enables us to return our focus where it belongs, which is on executing our business plans and delivering value for our shareholders."[41]

5. New York Judge Allows Claim Against Hedge Fund Administrator for Allegedly Transferring Funds to Chinese Hackers to Go Forward

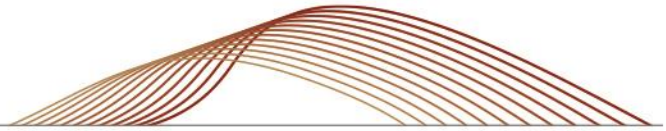
In our **Winter 2016 Report**, we reported that on September 16, 2016, hedge fund Tillage Commodities Fund, L.P. ("Tillage"), filed suit in New York Supreme Court for the County of New York against its fund administrator, SS&C Technologies, Inc. ("SS&C") for allegedly transferring millions of dollars from Tillage's accounts.[42] According to Tillage's complaint, the transfers were in response to "spoofing" emails that contained typos, account errors, and unusual syntax.[43] The fraudulent transfers were for millions of dollars (the largest was $3 million), while legitimate transfers by Tillage in the preceding four years ranged from $3,567 to $12,410.[44] The complaint alleged, "Either SS&C processed this series of fraudulent wire transfer requests without any review whatsoever, in total abdication of its obligations—or SS&C knowingly facilitated the fraud."[45] In response, SS&C filed a motion to dismiss contending that Tillage was bound by a contractual limitation of liabilities, which limited liability to "intentional wrongdoing or reckless disregard."[46] SS&C argued that the wire transfer requests "included confidential information regarding Plaintiff's account at First Republic Bank and bore signatures that exactly matched those of Plaintiff's authorized signatories."[47] Further, SS&C claimed that it acted immediately once it discovered the fraud, barring a finding of intentional wrongdoing or reckless disregard.[48] In response, Tillage argued that it alleged sufficient facts to show that SS&C acted with reckless disregard.[49]

On December 30, 2016, the court granted the motion to dismiss in part and denied the motion in part.[50] The court stated, "Accepting the allegations in the complaint as true, as the Court must on a pre-answer motion to dismiss, the Court finds that the pleadings suffice to state a cause of action."[51] The court further declined to address the contractual limitations of liability, noting, "Ordinarily the question of gross negligence is a matter to be determined by the trier of fact."[52] Nonetheless, the court did dismiss two statutory claims premised on deceptive business practices and false advertising.[53] The court reasoned that the controlling statutes were "consumer-oriented" and not applicable to a private contract dispute.[54]

B. New Developments in Securities Litigation

1. Ernst & Young Discloses Settlement of Suit by Hedge Fund Liquidators Over Accounting Practices

Accounting firm Ernst & Young ("E&Y") has settled a suit by Grant Thornton over E&Y's role as auditor for the hedge fund Weavering Macro ("Weavering").[55] Grant Thornton was serving as Weavering's liquidator at the time of the suit.[56] Weavering collapsed in 2009 during the global financial crisis, and Weavering (then in liquidation) was awarded $450 million in a civil suit in the United Kingdom against its former directors.[57] Weavering's liquidators subsequently filed suit in 2012 against E&Y in the Cayman Islands on behalf of Weavering, alleging deceit, breach of contract, and negligence in its audits of Weavering.[58] Weavering's liquidators received $10 million in exchange for discontinuing all claims against E&Y.[59]



2. Hedge Funds Reinstitute Suits Against Puerto Rico

Hedge funds holding Puerto Rico's general obligations bonds have reinstituted suits against the commonwealth after a stay imposed by the federal PROMESA law expired.[60] Certain of the funds filed suit in New York state court seeking overdue loan payments.[61] Others filed suit in U.S. District Court in San Juan to block the spending of tax revenue by the commonwealth before repaying bondholders.[62] Puerto Rico has previously stated that it was required to make certain general obligation payments from tax revenue under its constitution prior to paying bondholders.[63]

3. Hedge Fund Sues Consumer Financial Protection Bureau for Exceeding Its Authority

RD Legal Funding ("RDLF"), a hedge fund that invests in legal disputes, filed suit against the Consumer Financial Protection Bureau ("CFPB") on January 4, 2017.[64] The CFPB had been investigating the hedge fund for alleged unfair, deceptive, and abusive acts and practices related to payments to beneficiaries of funds for 9/11 first responders and former NFL players.[65] In its complaint, RDLF alleged that the CFPB's investigation exceeded the scope of the CFPB's authorizing legislation and that "the agency has violated RDLF's First Amendment rights by retaliating against RDLF for challenging the agency's jurisdiction" before the agency.[66] The CFPB and the New York Attorney General have since filed suit against RDLF in federal court for the Southern District of New York.[67] The agencies alleged, in addition to other unlawful sales and collection practices, that the fund provided upfront partial payments of settlement amounts to 9/11 first responders and NFL concussion survivors in exchange for the ability to collect much larger payments later once the claimants are paid from the victim compensation funds. The agencies allege that these transactions are, in reality consumer loans, and as such entail interest rates well above New York's usury interest caps.[68] Both cases have been assigned to Judge Loretta A. Preska.

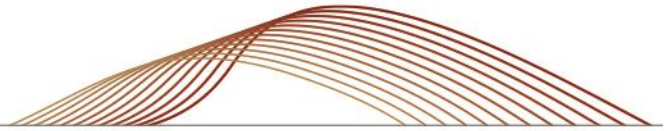
III. REGULATORY ENFORCEMENT

Although the enforcement landscape under the new administration remains largely uncharted, we do expect to see continued coordination between OCIE and the SEC's Enforcement Division in the context of examinations of private fund advisers. We expect greater scrutiny of issues regarding conflicts of interests and related disclosures, potential self-dealing and adviser self-interest—i.e., topics that were highlighted as examination priorities in 2017 by OCIE.

Below we have summarized various actions by the SEC's Enforcement Division that highlight some of the other areas that remain a focus of the SEC staff, including valuation, beneficial ownership, misappropriation of funds, pay-to-play, and Foreign Corrupt Practices Act ("FCPA") violations. We also included a summary of recent efforts by the SEC and CFTC to enhance their respective whistleblower programs. As the year develops, and as the SEC staff settles in under the leadership of Chairman Jay Clayton, we expect to provide additional insight as to the outlook for enforcement activity in 2018.

A. Valuation

The SEC remains active in ensuring that investment advisers accurately value assets under management. Below is a summary of a recent SEC administrative proceeding against an investment advisory firm for incorporating improper valuation figures prepared by a third-party vendor into quarterly and annual financial statements of the managed funds.



In the Matter of Covenant Financial Services, LLC and Stephen Shafer

On March 29, 2017, the SEC announced settled public administrative and cease-and-desist proceedings against Covenant Financial Services LLC ("Covenant") and Stephen Shafer ("Shafer"), Covenant's portfolio manager and Chief Investment Officer, for materially misstating the value of assets in five private funds.

The SEC alleged that Covenant provided advisory services to five funds, two of which were considered offshore funds ("Offshore Funds"), and three of which were deemed onshore funds ("Onshore Funds"). The Private Placement Memoranda ("PPMs") for certain funds stated that their net asset value would be determined in accordance with GAAP, while the PPMs for certain other funds simply stated that the value of the assets of those funds would be determined in good faith. Additionally, Covenant's internal valuation policy stated that assets held by all of its funds would be valued in accordance with GAAP, and that in measuring fair value of an asset, Covenant would maximize the use of observable inputs (i.e., quoted prices in active markets for the same or similar assets or other similar price indicators) and minimize the use of unobservable inputs (i.e., factors and price indicators that could be used when there is little, if any, market activity for an asset).

The SEC alleged that, during 2011, which included periods of market volatility, Covenant used a pricing service ("Pricing Service") that estimated asset values based on a model that required unobservable inputs, as opposed to quoted market prices based on the sales of similar bonds. As a result, the Pricing Service supplied Covenant with values of certain municipal bonds that did not take into account the quoted market prices for the sale of similar bonds, broker marks for those assets or applicable broker quotes.

According to the SEC, the Pricing Service values were inconsistent with the statements contained in the PPMs of the Onshore Funds and Offshore Funds and Covenant's internal valuation policy concerning Covenant's methodology for valuation. Specifically, the SEC alleged that the valuation methodology used by the Pricing Service was inconsistent with GAAP and that Covenant's reliance on the methodology was not in good faith because Covenant apparently sold some of the municipal bonds in question during the relevant time period at prices lower than those provided by the Pricing Service without making any adjustment for the variance in prices.

By incorporating the Pricing Service valuations into the financial statements of the funds, Covenant allegedly overstated the respective performance of the funds (between 3.43% to 6.99% in monthly and quarterly reports) during the relevant period. Additionally, the SEC alleged that the valuation error caused Covenant to improperly receive more than $400,000 in excess management fees and incorrectly calculate redemptions from the funds during the period.

The SEC Order also noted that Covenant's auditor identified the valuation issue during an audit of the funds for the 2012 calendar year, and shortly thereafter, Covenant refunded approximately $440,000 in excess management fees to the funds and paid $270,000 to the funds as a partial payment of the $3 million overpayment of redemptions that were made to investors during 2011 and 2012 based on the inflated valuations.

Without admitting or denying the allegations, Covenant and Shafer consented to the entry of an Order directing them to cease-and-desist from future violations of Sections 203(e), 203(f), and 203(k) of the Advisers Act. In addition, Covenant and Shafer were censured and required to pay a civil penalty of $130,000 and prejudgment interest of $14,845.78.

B. Failure to Disclose Beneficial Ownership

On February 14, 2017, respondents in In the Matter of Jeffrey E. Eberwein; Lone Star Value Management, LLC; Charles M. Gillman; Boston Avenue Capital, LLC; and Heartland Advisors, Inc. consented to the entry of an SEC administrative order arising out of allegations that the respondents, while acting as a group, failed to publicly disclose beneficial ownership holdings of over five percent and 10 percent of multiple public companies as required by Section 13(d) and 16(a) of the Securities Exchange Act of 1934 (the "Exchange Act"), respectively. This matter is noteworthy because it represents one of the few occasions where the SEC has taken enforcement action against multiple individuals and entities based on the group theory of reporting under the beneficial ownership reporting requirements of Sections 13(d) and 16(a).

Generally, Section 13(d) and its related rules require any person who has acquired beneficial ownership of five percent or more of certain equity securities to file a statement on Schedule 13D with the SEC within 10 days of acquiring such beneficial ownership. If the individual acquired the securities in the ordinary course of business and not with the purpose or the effect of changing or influencing the control of the issuer, nor in connection with any transaction having such purpose of effect, the person may file a statement of beneficial ownership on a short-form Schedule 13G, which requires substantially less information than Schedule 13D. Section 16(a) requires beneficial owners of more than 10% of a class of equity registered under Section 12 to file a statement reporting beneficial ownership, as changes thereto, within 10 days of becoming a 10% beneficial owner. Importantly, Sections 13(d) and 16(a) define the term "person" to include individuals and entities that act as a group for the purpose of acquiring, holding, or disposing of securities of an issuer, such that the individuals and entities must disclose their joint efforts and holdings as a group on required beneficial ownership forms. Notably, it is not necessary for individuals to have entered into a formal agreement with respect to their collective ownership in order for the reporting obligation to apply.

In this action, the SEC alleged that the investors, while acting as a group, failed to properly disclose their collective beneficial ownership holdings and accurately describe their efforts to bring about corporate change in beneficial ownership forms in connection with the five public issuers. Specifically, the SEC alleged that, in connection with certain shareholder activist campaigns, the investors failed to take the following necessary steps:

1. disclose the existence of, or collaboration by, the investor group in the beneficial ownership forms;
2. file the proper beneficial ownership form to indicate the group's intent to bring about corporate change;
3. fully disclose the group's plans for the intended change in control; and
4. timely file beneficial ownership forms (allegedly because the group wanted additional time to acquire more stock and to reduce the issuer's ability to use defensive measures).

Without admitting or denying the findings, each of the respondents consented to an order directing them to cease-and-desist from future violations of Sections 13(d) and 16(a) and related rules, and to pay penalties in the following amounts: $90,000 for Eberwein, $30,000 for Gillman, $120,000 for Lone Star Value Management, and $180,000 for Heartland Advisors.

C. Misappropriation of Funds

We summarize below a recent enforcement action in which the SEC alleged "cherry picking" violations by a registered investment adviser and its principal. This matter is noteworthy in that it highlights the SEC's continued reliance on data analytics to identify suspicious trading patterns. In fact, Joseph G. Sansone, Co-Chief of the SEC Enforcement Market Abuse Unit, commented on the matter, stating "Our probing analytical work will continue to root out investment advisers who subject their clients to cherry-picking."

SEC v. Strategic Capital Management, LLC and Michael Breton

On January 25, 2017, the SEC filed a civil complaint against Michael J. Breton and his advisory firm, Strategic Capital Management, for engaging in a "cherry-picking" scheme that defrauded clients out of approximately $1.3 million.

The SEC alleged that Breton violated 10(b) and Rule 10b-5 of the Exchange Act and Sections 206(1) and 206(2) of the Advisers Act by, over a six-year period, placing trades through a master brokerage account and allocating the most profitable trades to his personal account, while placing the poor performing trades into client accounts.

In a partial settlement of the action, Breton agreed to be permanently barred from the securities industry. The SEC complaint also seeks disgorgement and civil penalties. In a parallel criminal proceeding based on the same conduct, Breton pleaded guilty to one count of securities fraud.

D. Pay-to-Play

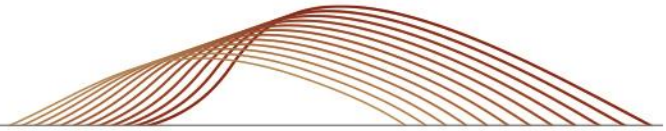
On January 17, 2017, the SEC announced settlements with 10 investment advisory firms for pay-to-play rule violations. The SEC orders alleged that the investment advisory firms received compensation from public pension funds—specifically, advisory fees from city or state pension funds—within two years after the firms' associates had made contributions to elected official or political candidates with the potential to exercise influence over those pension funds.

Under Section 206(4) of the Advisers Act, investment advisers are subject to a two-year timeout from providing compensatory advisory services, either directly to a government client or through a pooled investment vehicle, after political contributions were made to a candidate who could either influence the investment adviser selection process for a public pension fund or appoint someone with such influence. It is of no consequence that there was no quid pro quo in connection with the contribution—the rule acts as a blanket prohibition against any donation, in excess of certain *de minimis* amounts, made within the two-year period.

Each of the advisory firms consented to an SEC order directing them to cease-and-desist from future violations of the pay-to-play rule without admitting or denying the findings, and the firms agreed to pay penalties ranging from $35,000 to $100,000.

E. FCPA

We expect the U.S. Department of Justice ("DOJ") and SEC to remain active in FCPA investigations in the private fund space, especially on the heels of well-publicized resolutions with financial services companies. Additionally, the DOJ has announced that the FCPA is an area of focus under the new administration. Attorney General Jeff Sessions delivered remarks at the Ethics and Compliance Initiative Annual Conference characterizing FCPA as a "critical" area that the DOJ will "continue to strongly enforce." Attorney General Sessions also noted that the DOJ "will continue to emphasize the



importance of holding individuals accountable for corporate misconduct" and that charging decisions "will continue to take into account whether companies have good compliance programs; whether they cooperate and self-disclose their wrongdoing; and whether they take suitable steps to remediate problems."

F. Whistleblowers

Since the inception of its whistleblower program, the SEC has awarded more than $154 million to whistleblowers. The largest awards so far this year consisted of the following:

1. January 6 – $5.5 million;
2. January 23 – $7 million (split amongst three whistleblowers); and
3. April 25 – $4 million.

According to the SEC, enforcement actions it brought as a result of whistleblower tips have generated over $950 million in financial remedies.

In addition to continued promotion of its whistleblower program through large-scale awards, the SEC has pursued actions against financial services firms that, in the SEC's view, impede potential whistleblowers from coming forward with information. Those actions have generally alleged that the firms, through the use of certain restrictive language in severance agreements, have inhibited an employee's ability to act as a whistleblower, which according to the SEC, is in violation of the SEC's whistleblowing rules.

Whistleblowing and the CFTC

Another notable development is the CFTC's recent passage of amendments aimed at strengthening its whistleblower program. On May 22, 2017, the CFTC unanimously approved amendments, which effectively (a) bolster anti-retaliation protections, (b) prohibit clauses in confidentiality and employment agreements that may impede whistleblowers from communicating with the CFTC, and (c) increase potential awards.

While the amendments are in part intended to harmonize the CFTC's whistleblower program with that of the SEC, a notable distinction under the CFTC regime is the ability of whistleblowers to collect financial awards for reporting information without being the original source of the information. Moreover, a whistleblower remains eligible for an award under the CFTC program even if they first reported the information to another regulatory authority (such as the SEC or DOJ) before reporting to the CFTC, and the whistleblower can collect a bounty for information reported in either the covered CFTC action or a related action, so long as they had not been granted an award by the SEC for the same action under the SEC's whistleblower program. Compared with the SEC whistleblower program—which requires whistleblowers to provide original information—the CFTC rules make it easier for whistleblowers (especially those who first report to the SEC and later to the CFTC) to be eligible for recovery.

Our prior Reports are available here:

Winter 2016, Spring 2016, Fall 2015, Spring 2015, Fall 2014, Spring 2014, Fall 2013, Spring 2013, Fall 2012, Spring 2012, Fall 2011, and Spring 2011.

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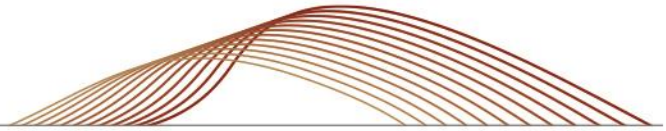


If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Private Fund and Regulatory Tax

London

Arun Birla
1.44.20.3023.5176
arunbirla@paulhastings.com

Diala Minott
44.020.3023.5181
dialaminott@paulhastings.com

Christian Parker
1.44.20.3023.5161
christianparker@paulhastings.com

Duncan Woollard
1.44.20.3023.5134
duncanwoollard@paulhastings.com

Karen Stretch
1.44.20.3023.5194
karenstretch@paulhastings.com

Los Angeles

Siobhan Burke
1.213.683.6282
siobhanburke@paulhastings.com

Yousuf Dhamee
1.213.683.6179
yousufdhamee@paulhastings.com

Arthur L. Zwickel
1.213.683.6161
artzwickel@paulhastings.com

David Hong
1.213.683.6223
davidhong@paulhastings.com

New York

Larry Hass
1.213.318.6401
larryhass@paulhastings.com

Tram Nguyen
1.213.318.6848
tramnguyen@paulhastings.com

Thomas Rao
1.213.318.6838
thomasrao@paulhastings.com

Michael R. Rosella
1.212.318.6800
mikerosella@paulhastings.com

Josh Sternoff
1.212.318.6011
joshsternoff@paulhastings.com

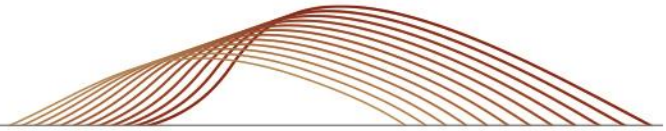
Craig Spenner
1.212.318.6842
craigspenner@paulhastings.com

Palo Alto

Thomas S. Wisialowski
1.650.320.1820
thomaswisialowski@paulhastings.com

San Francisco

David A. Hearth
1.415.856.7007
davidhearth@paulhastings.com



Private Fund Litigation and Enforcement

London

Michelle Duncan
1.44.20.3023.5162
michelleduncan@paulhastings.com

Los Angeles

Nick Morgan
1.213.683.6181
nicolasmorgan@paulhastings.com

William F. Sullivan
1.213.683.6252
williamsullivan@paulhastings.com

Tom A. Zaccaro
1.213.683.6185
thomaszaccaro@paulhastings.com

New York

Kenneth M. Breen
1.212.318.6344
kennethbreen@paulhastings.com

Kevin P. Broughel
1.212.318.6483
kevinbroughel@paulhastings.com

Barry G. Sher
1.212.318.6085
barrysher@paulhastings.com

John P. Nowak
1.212.318.6493
johnnowak@paulhastings.com

Palo Alto

Edward Han
1.650.320.1813
edwardhan@paulhastings.com

Peter M. Stone
1.650.320.1843
peterstone@paulhastings.com

San Diego

Christopher H. McGrath
1.858.458.3027
chrismcgrath@paulhastings.com

San Francisco

Grace A. Carter
1.415.856.7015
gracecarter@paulhastings.com

Washington, D.C.

Morgan J. Miller
1.202.551.1861
morganmiller@paulhastings.com

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[1] This portion of the report was prepared with the assistance of Mourant Ozannes, a leading international law firm that advises on the laws of the British Virgin Islands, the Cayman Islands, Guernsey, and Jersey.

[2] Terms in italics are defined terms in the Amended Regulations.

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[25] *Good Hill Master Fund L.P. v. Deutsche Bank AG*, 2016 WL 3580032 at *1 (N.Y.Sup. 2016).

[26] *Id.*

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[28] Notice of Appeal, *Good Hill Master Fund L.P. v. Deutsche Bank AG*, Index No. 600858/10 (N.Y. Sup. Mar. 4, 2016), Dkt. No. 233.

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[44] *Id.* ¶ 57.

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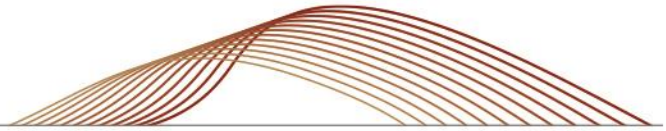
[48] *Id.*



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[67] Complaint, *CFPB v. RD Legal Funding LLC*, No. 17-00890 (S.D.N.Y. Feb. 7, 2017)

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