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October 2010

Hedge Fund Report –
Summary of Key Developments – Fall 2010

BY THE INVESTMENT MANAGEMENT, SECURITIES LITIGATION & TAX PRACTICES

In response to nearly unprecedented disturbances and failures in the global capital markets in late 2008 and 2009, the Obama Administration, lawmakers and regulators proposed a variety of significant legal and regulatory reforms that would have the potential to change the nature of financial services regulation in the United States and beyond. These efforts culminated in the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"),[1] the single most important and comprehensive piece of financial system reform legislation since the myriad reforms following the Great Depression. Meanwhile, Congress, the Internal Revenue Service (the "IRS"), the Securities and Exchange Commission (the "SEC") and private litigants have been busy creating new tax rules and sorting through the aftermath of the financial disruption as evidenced by recent enforcement and private actions.

This report provides an update since our last report in March 2010 (available here) and highlights recent developments, particularly the Dodd-Frank Act, 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 Act

President Obama signed the Dodd-Frank Act into law on July 21, 2010, almost two years after the collapse of Lehman Brothers. The Lehman collapse marked the beginning of a period of extreme stress and volatility in the global capital markets and prompted a flood of legal and regulatory reform proposals. Intended 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," the 2,300-page 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. The following summarizes those provisions of the Dodd-Frank Act that are most relevant to the hedge fund industry. The full text of the Dodd-Frank Act is available here.

1. Registration of Private Fund Advisers

One of the important changes to the registration requirements of investment advisers is the elimination of the "private adviser" exemption that was previously contained in Section 203(b)(3) of the Investment Advisers Act of 1940, as amended (the "Advisers Act"). This provision generally exempted from SEC registration any investment adviser that, in the course of the preceding 12 months, (a) had fewer than 15 clients and (b) did not hold itself out to the public as an investment adviser or act as an investment adviser to any registered investment company or business development company. Investment advisers that previously relied on this exemption may be required to register with the SEC, unless they qualify for another existing or new exemption under the Advisers Act. The Dodd-Frank Act created a number of new exemptions, including exemptions for small investment advisers (*i.e.*, those advisers with less than $150 million in assets under management ("AUM")) with only "Private Fund" clients *(i.e.*, hedge funds, private equity funds and certain real estate funds that rely on the exclusions contained in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (the "Investment Company Act")), "Foreign Private Advisers"[2] and investment advisers with only "Venture Capital Fund" [3] clients. The Dodd-Frank Act also increases the role of states in overseeing and regulating the activities of investment advisers by requiring each investment adviser with AUM of between $25 million and $100 million (subject to certain exceptions) to register with the state in which it has its principal place of business (instead of with the SEC) if it is required by the state to be so registered. Investment advisers required to be registered under the Dodd-Frank Act must register with the SEC by July 20, 2011, although an investment adviser may voluntarily register with the SEC prior to the deadline. Additional information on the registration requirements of investment advisers is available here.

2. Record-Keeping and Reporting Requirements

Under the Dodd-Frank Act, registered investment advisers are required to maintain and make available to the newly established Financial Stability Oversight Council (the "Oversight Council") records of, and file reports with the SEC regarding, each Private Fund they advise. These records include the following information (the "Private Fund Information"): (a) the amount of AUM and use of leverage (including off-balance sheet leverage); (b) counterparty credit risk exposure; (c) trading and investment positions; (d) valuation policies and practices of the funds; (e) types of assets held; (f) side arrangements or side letters; (g) trading practices; and (h) such other information as the SEC determines, in consultation with the Oversight Council, to be necessary and appropriate in the public interest for the protection of investors or for the assessment of systemic risk. The Private Fund Information will be subject to periodic inspections or special examinations by the SEC, and the SEC is also authorized to vary the reporting requirements of an investment adviser in accordance with the type or size of the Private Fund it advises. Significantly, although the record-keeping and reporting requirements described above are only applicable to registered investment advisers, unregistered Private Fund investment advisers with AUM of less than $150 million and advisers to Venture Capital Funds may be subject to such future record-keeping and reporting requirements as the SEC may deem necessary or appropriate. Finally, the Dodd-Frank Act requires the SEC to issue rules with respect to the new record-keeping and reporting requirements by July 20, 2011.

3. *Information Sharing and Confidentiality*

The Dodd-Frank Act requires the SEC to share any Private Fund Information filed with, or provided to, the SEC with the Oversight Council and other federal departments, agencies or self-regulatory organizations. The SEC may not withhold any Private Fund Information from Congress and must comply with any proper request for Private Fund Information made by other U.S. federal departments, agencies or self-regulatory organizations. Further, the Oversight Council or any other recipient of Private Fund Information must keep such information confidential, and Section 929I of the Dodd-Frank Act provides for an exemption for the SEC from requests for such information made pursuant to the Freedom of Information Act (the “Section 929I Exemption”). The Section 929I Exemption, however, came under fire, and several bills to repeal the Section 929I Exemption were introduced in Congress soon after its enactment. Despite SEC Chairman Mary Schapiro’s warning that the repeal would hinder the SEC’s examination capability because advisers would be less willing to hand over sensitive documents for fear of losing their competitive advantages, on September 21, 2010, the Senate Judiciary Committee unanimously approved a bill to repeal the Section 929I Exemption. The house passed the bill on September 23, 2010, and President Obama eventually signed it into law on October 5, 2010. The repeal limits, but does not eliminate, the SEC’s ability to shield certain information from public disclosure because the SEC can continue to rely on the narrower Exemption 8 under the Freedom of Information Act. The repeal also clarifies an area of ambiguity under Exemption 8 by defining the previously undefined term “financial institution” as “any entity” that the SEC is responsible for “regulating, supervising, or examining.”

4. *Changes to the Definition of “Accredited Investor” and the “Qualified Client” Standards*

Prior to the adoption of the Dodd-Frank Act, a natural person qualified as an “Accredited Investor” under Regulation D under the Securities Act of 1933, as amended, if that person’s individual net worth, or joint net worth with that person’s spouse, exceeded $1,000,000 at the time of purchase. The Dodd-Frank Act amended the definition of “Accredited Investor” to exclude the value of a natural person’s primary residence from that person’s net worth, which effectively increases the net worth threshold for qualifying as an “Accredited Investor.” Unlike most other provisions under the Dodd-Frank Act, which have a transition period of one year, the changed definition of “Accredited Investor” took effect immediately, and investment advisers should promptly revise the subscription and disclosure documents of the funds they advise. The SEC has issued an interpretation to clarify the treatment of indebtedness secured by the primary residence (*i.e.*, a mortgage) in calculating a natural person’s net worth for purposes of qualifying as an “Accredited Investor” (mortgage debt up to the value of the primary residence will not reduce net worth). With respect to the “Qualified Client” standards under the Advisers Act’s performance fee rule, the Dodd-Frank Act requires the SEC to adjust the dollar amount in connection with the “Qualified Client” standards for inflation by July 20, 2011 and every five years thereafter. Currently, a “Qualified Client” is defined under Advisers Act Rule

205-3(d)(1) to include a natural person who has a net worth, either individually or jointly with that natural person's spouse, of more than $1.5 million or who has at least $750,000 under the management of the investment adviser.

5. The Volcker Rule

Section 619 of the Dodd-Frank Act, also known as the "Volcker Rule" because of the former Chairman of the Federal Reserve Paul Volcker who first advanced the proposal, generally prohibits any "Banking Entity"[4] from engaging in proprietary trading and from sponsoring and investing in Private Funds.[5] The term "sponsor" is defined broadly to include: (a) serving as the general partner, managing member or trustee of a Private Fund, (b) selecting or controlling, in any manner, a majority of the directors, trustees or management of a Private Fund; and (c) sharing the same name or a variation thereof with a Private Fund. The Volcker Rule does, however, provide for a number of categories of activities a Banking Entity is permitted to engage in, including trading in government securities, trading for risk mitigation, trading for customers, organizing and offering a private equity fund or hedge fund where the Banking Entity provides *bona fide* trust, fiduciary or investment advisory services, and investing in or sponsoring hedge funds or private equity funds that occur solely outside the United States. Most of these exemptions are subject to the satisfaction of certain conditions, and regulators are required to adopt rules to impose additional capital requirements and quantitative limits on the permitted activities. The Volcker Rule will become effective upon the earlier of one year after the issuance of final rules or July 20, 2012, and Banking Entities will then have two years to be in compliance. Additional information on the Volcker Rule is available at the following links: A New Era in the Regulation of Private Investment Funds and The Dodd-Frank Wall Street Reform and Consumer Protection Act: Impact on Banks.

6. Oversight of Over-the-Counter Derivatives

Title VII of the Dodd-Frank Act contains comprehensive legislation of over-the-counter derivates and establishes a new regulatory framework under which the Commodity Futures Trading Commission (the "CFTC") will have jurisdiction over swaps, swap dealers and major swap participants, while the SEC will have jurisdiction over security-based swaps, security-based swap dealers and major security-based swap participants. Key provisions that impact over-the-counter derivatives under the Dodd-Frank Act include: (a) registration of swap dealers and major swap participants with the CFTC and/or the SEC; (b) mandatory clearing and exchange trading and related exceptions; (c) real-time public reporting of swap transaction data, including pricing and volume data; (d) compliance with CFTC or SEC business conduct standards by swap dealers and major-swap participants; (e) capital and margin requirements for swap dealers and major swap participants; and (f) positions limits. The CFTC, SEC and appropriate regulators now face the difficult task of conducting required studies and drafting specific rules to address a number of open issues, including the definition of certain key terms, the type of swap transactions subject to the mandatory clearing requirement, the specific capital and margin requirements and the specific limits on position holdings. Additional information on over-the-counter derivatives regulation changes is available here.

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

1. SEC Final Rules on Pay-to-Play

On July 1, 2010, the SEC, by a unanimous vote, adopted final rules, including new Rule 206(4)-5 and amendments to Rules 204-2 and 206(4)-3 under the Advisers Act, to address the pay-to-play practices of investment advisers. The final rules will impact not only investment advisers and third-party solicitors (*e.g.*, placement agents), but also local and state governments, elected officials and political parties. Specifically, the final rules restrict political contributions by investment advisers by generally prohibiting an investment adviser covered by the rules from receiving compensation, directly or indirectly, for providing investment advisory services to certain government entities for two years after the investment adviser or a covered associate of the investment adviser makes a contribution to certain elected government officials or candidates. The two-year "look-back" period will be reduced to six months if the covered associate does not solicit clients. A "look-forward" provision was included in the final rules mandating the continued applicability of the look-back period even when the covered associate who made the contribution is no longer employed by the investment adviser. Additionally, the final rules also prohibit a covered investment adviser and its covered associates from coordinating, or soliciting from others, contributions to certain elected government officials, or to a political party, where the investment adviser provides or seeks to provide investment advisory services to a government entity. While the final rules are similar to the proposed rules issued on August 3, 2009 in many respects, the final rules made certain significant changes to the proposed rules in response to the comment letters the SEC received, including replacing the proposed absolute ban on third-party solicitation with a conditional ban that allows the use of a third-party solicitor if the third-party solicitor is registered as an investment adviser with the SEC or is a registered broker-dealer subject to similar pay-to-play regulations of a national securities association such as the Financial Industry Regulatory Authority (FINRA). The final rules also contain provisions that require investment advisers registered with the SEC to maintain certain records of political contributions and payments to third-party solicitors. The final rules took effect on September 13, 2010 but will be phased in over the course of one year. Additional information on the final rules on pay-to-play is available here.

2. <u>Interim Final Regulation on Improved Fee Disclosure for Pension Plans</u>

On July 16, 2010, the Department of Labor published an interim final regulation relating to improved fee disclosure requirements for service providers of pension plans. Under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), an ERISA plan is prohibited from making payments to a service provider unless exempted under Section 408(b)(2). This exemption is available only where the contract or arrangement between the ERISA plan and the service provider is "reasonable," the services are necessary for the establishment or operation of the ERISA plan and no more than reasonable compensation is paid for the services. The interim final regulation 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. Significantly, service providers to an investment contract, product or entity in which a covered plan invests (including hedge funds or other pooled investment vehicles) are not subject to the interim final regulation unless such service providers are fiduciaries. Nevertheless, the interim final regulation noted that even if a contract or arrangement falls outside of its scope because it does not involve a covered plan or a covered service provider, the contract or arrangement still has to be reasonable in order to qualify for the Section 408(b)(2) exemption. The interim final regulation is to take effect on July 16, 2011 and once effective, is to apply to all pre-existing and new contracts or arrangements. Additional information on the interim final regulation is available here.

3. <u>New Brochure Requirement for Registered Advisers</u>

On July 28, 2010, the SEC adopted amendments to Part 2 of Form ADV and related rules under the Advisers Act to require investment advisers registered with the SEC to provide enhanced disclosures to new and prospective advisory clients. Initially proposed in March 2008, the final rules make significant changes to the disclosures that a registered investment adviser must make on Part 2 of Form ADV. Specifically, multiple-choice and fill-in-the-blank questions were eliminated in the amended Part 2 of Form ADV and replaced with a narrative brochure written in plain English addressing 18 items about an investment adviser's business strategies and conflicts of interest. In addition, a new brochure supplement addressing six items about certain of the investment adviser's personnel was added. The brochure (not including the brochure supplement) must be filed with the SEC electronically and will be made available to the public through the SEC's website. These changes are designed to provide clients with more detailed information about investment advisers and their personnel in an improved format and more meaningful manner. Additional information on the amendments to Part 2 of Form ADV is available here.

4. "Final" SEC Rules on Shareholder Proxy Access

On August 25, 2010, the SEC issued the long-awaited final rules on shareholder proxy access, including the new Rule 14a-11 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), to facilitate shareholders in exercising their rights to nominate and elect directors of public companies. Under Rule 14a-11, a public company is required to include nominees for directors proposed by any shareholder or group of shareholders in the company's proxy statement if such shareholder or group of shareholders owns at least 3% of the voting securities of the company and has held such securities for at least three years. To have the nominees included on the proxy statement, the nominating shareholder or group of shareholders must file with the SEC, and provide to the company, a notice on the new Schedule 14N (containing specified information) no earlier than 150 days and no later than 120 days before the anniversary of the date the company mailed its proxy materials for the prior year's annual meeting. With limited exceptions, the final rules on shareholder proxy access apply to all companies subject to the proxy rules, including registered investment companies. The final rules are to become effective on November 15, 2010 and will apply for the 2011 proxy season to companies that mailed their 2010 proxy materials on or after March 15, 2010. However, because of the petition filed by Business Roundtable and the Chamber of Commerce of the United States of America with the United States Court of Appeals for the District of Columbia Circuit seeking review of the final rules, the SEC issued an order on October 4, 2010 granting a stay of the implementation of the final rules pending resolution of the petition. Although it is expected that large institutional investors will take advantage of the newly expanded proxy access, some have argued that the final rules will also make it easier and faster for financial activists, including activist hedge funds, to engage in proxy contests. Additional information on the final rules on shareholder proxy access is available here.

II. TAXATION

A. Regulatory Update on Disclosure Requirements (FBAR)

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 Hiring Incentives to Restore Employment Act (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.

B. New Legislation

1. Broad Changes to U.S. Withholding Rules - Increased Disclosure of Beneficial Owners

a. Generally

Reporting on certain foreign financial accounts. The Foreign Account Tax Compliance Act ("FATCA") provisions of the HIRE Act impose a 30% withholding tax on certain income from U.S. financial assets held by a foreign financial institution ("FFI") unless the FFI agrees to disclose the identity of any U.S. person with an account and to report annually on the account balance, gross receipts and gross withdrawals/payments from such account. If an FFI does not comply with these disclosure and reporting requirements, such payments will be subject to the 30% withholding tax.

Reporting on owners of foreign corporations, foreign partnerships and foreign trusts. FATCA generally requires foreign entities to provide withholding agents with the name, address and tax identification number of any U.S. individual that is a substantial owner of the foreign entity. Withholding agents are to report this information to the IRS. The HIRE Act exempts publicly held and certain other foreign corporations from these reporting requirements and provides the Treasury Department with the regulatory authority to exclude other recipients that pose a low risk of tax evasion. Any withholding agent making a withholdable payment to a foreign entity that does not comply with these disclosure and reporting requirements is required to withhold tax at a rate of 30%.

These provisions are effective generally for payments made after 2012. Additional information on the changes to U.S. withholding rules is available here.

b. *Notice 2010-60*

On August 27, 2010, the IRS released initial guidance on FATCA in Notice 2010-60 ("Notice"). The Notice addresses the scope of the grandfathered obligations exception of the HIRE Act, the definition of an FFI, the scope of information collection and the information about U.S. account holders to be reported by FFIs under an agreement with the IRS.

Grandfathered obligations. Payments on obligations outstanding on March 18, 2012 are not subject to withholding under the HIRE Act. The IRS clarified that this exemption does not cover an obligation treated as equity for U.S. tax purposes or lacks a definitive expiration or term (such as a checking or savings account). Moreover, a material modification of an obligation after March 18, 2012 may result in the obligation being treated as newly issued on the date of the modification, causing it to lose grandfathered status.

Definition of FFI. An FFI is broadly defined to include any entity that (i) accepts deposits in the ordinary course of a banking or similar business, (ii) holds financial assets for the account of others as a substantial portion of its business or (iii) is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting or trading in securities. The IRS, however, is authorized to identify classes of financial institutions that will not be treated as FFIs, or that will be deemed to have complied with the HIRE Act's reporting requirements.

Scope of information collection. The Notice sets out detailed rules containing presumptions regarding the status of existing and new accountholders and information that must be obtained to overcome those presumptions. In general, an FFI will need an IRS Form W-9 for each pre-existing or new accountholder and will require documentary evidence, such as an IRS Form W-8 to establish non-U.S. status.

Compliance with reporting requirements. FFIs must generally enter into an agreement with the IRS to avoid withholding under the HIRE Act. The specific requirements will depend on whether an account is a pre-existing account or is opened after the FFI enters into the agreement with the IRS, and on whether the accountholder is an individual or entity.

2. *Extension of Statute of Limitations for U.S. Tax Returns*

With some exceptions, taxes generally must be assessed within three years after a taxpayer's return was filed, whether or not it was timely filed. If a false or fraudulent return was filed with the intent to evade tax, or if the taxpayer fails to file a required return, the tax may be assessed at any time. A special six-year period of limitations applies when a taxpayer omits from the gross income an amount that is greater than 25% of the amount of the gross income stated in the return. This extended six-year assessment period also applies where a partnership omits an amount from its gross income that is over 25% of the gross income stated on the partnership return.

New legislation. For returns filed after March 18, 2010 and for any other return for which the assessment period has not yet expired as of this date, the HIRE Act provides that a new six-year period of limitations applies for assessment of tax on understatements of income attributable to foreign financial assets. This limitation period applies if there is an omission of gross income in excess of $5,000, and the omitted gross income is attributable to a reportable foreign asset for which information reports are required without regard to (i) the dollar threshold, (ii) the statutory exception for nonresident aliens and (iii) any other exceptions provided by the regulations.

The extended limitations period rules for foreign financial asset omissions is also applicable where a partnership omits such foreign financial assets. If a domestic entity is formed or availed of to hold foreign financial assets, it is subject to the reporting requirements in the same way as an individual and may also be subject to the six-year period of limitations.

Additional information on the extension of statute of limitations for U.S. tax returns is available here.

III. CIVIL LITIGATION

Hedge funds are currently involved in litigation, both as defendants and plaintiffs, involving a wide variety of issues. For example, courts have had to decide whether shares in hedge funds should be considered "covered securities" under the Securities Litigation Uniform Standards Act of 1998 ("SLUSA") and whether an e-mail to a visitor of a hedge fund's website constitutes an offer of unregistered securities. However, many of the litigation matters being pursued reflect the after-effects of the global recession, subprime fallout, and general economic turmoil of the past few years. For example, the New York Supreme Court allowed a liquidating trustee of a hedge fund to claw back withdrawals made to certain investors. Several lawsuits have been filed by hedge funds against a major investment bank for the latter's alleged practices in marketing and short-selling of subprime CDOs. The fallout from a Ponzi scheme continues in litigation in the Eastern District of Pennsylvania. Lawsuits challenging disclosures of high-risk investment strategies were dismissed in the Southern District of New York, both in favor of and against hedge funds. The Southern District of New York also dismissed an investor's lawsuit against a fund for the latter's investment in Bernard L. Madoff Securities LLC. Finally, an investor's attempt to petition for liquidation in order to pressure the hedge fund to pay a redemption request was rejected.

A. Update on Previously Reported Cases

Several of the cases reported in previous issues of Hedge Fund Report continue to progress through litigation.

1. Hedge Fund Shares Are Not Covered Securities Under SLUSA: The Pension Committee of the University of Montreal Pension Plan

In February 2004, a group of investors brought suit under federal securities law and New York state law to recover losses of $550 million stemming from the liquidation of two British Virgin Islands-based hedge funds in which they held shares, Lancer Offshore, Inc. and OmniFund, Ltd. (the "Funds"). Previously, we reported on a discovery dispute for which defendants sought terminating sanctions. The Southern District of New York sanctioned the plaintiffs for discovery spoliation but allowed the litigation to continue.

In a subsequent decision, the court addressed whether portfolios holding shares of a hedge fund should be considered "covered securities" under SLUSA.[6] A "covered security" is "one traded nationally and listed on a regulated national exchange or issued by an investment company that is registered, or files registration statements, under the Investment Company Act."[7] If the shares are considered covered securities, SLUSA preempts state law actions based on allegations of an untrue statement or omission in connection with the purchase or sale of those shares.

The plaintiff investors alleged that the former directors, administrator, auditor, prime broker, and custodian of the Funds made untrue statements of material fact about the Funds' net asset values and performance. The defendants moved for summary judgment on plaintiff's state law claims on the basis of SLUSA preemption, arguing that, while the Fund shares were not themselves covered securities, the portfolios of the Funds held covered securities. Judge Scheindlin rejected that argument and denied summary judgment, explaining that the defendants' alleged misstatements concerned the Funds themselves and not the investments held by the Funds.

This case is significant in that it rejected an expansive interpretation of the scope of SLUSA. The court made it clear that portfolios consisting of covered securities cannot on that basis be considered covered securities themselves and concluded that any other holding would "stretch[ ] the statute beyond its plain meaning."

2. *Offering Unregistered Securities in E-mail Violates Massachusetts Law: Bulldog Investors General Partnership*

The last issue reported a case in which the Massachusetts Securities Division filed an administrative complaint against Bulldog Investors, a partnership consisting of several hedge funds ("Bulldog"). The complaint alleged that Bulldog violated the Massachusetts Uniform Securities Act by offering securities for sale that were not properly registered or exempt. Bulldog raised the affirmative defense that the complaint abridged its rights under the First Amendment to the U.S. Constitution. Implementing the four-part First Amendment test in *Central Hudson Gas v. Public Serv. Comm'n*, 447 U.S. 557, 561 (1980), the court determined that Bulldog's First Amendment rights had not been violated.[8]

On July 2, 2010, the Massachusetts Supreme Judicial Court found that Bulldog had violated the Massachusetts Uniform Securities Act when it offered unregistered securities to a Massachusetts resident via e-mail.[9] The resident had registered with Bulldog's publicly accessible website by providing his name, address, telephone number, fax number, and e-mail address. A Bulldog employee then responded to this registration by sending an e-mail attaching materials regarding the performance of Bulldog's hedge funds, the returns the funds had earned, background information on Bulldog's partners, news articles about the funds, and a description of Bulldog's investment strategy and philosophy. The Bulldog employee also invited the resident to contact him to discuss Bulldog's funds in further detail.

The court held that Bulldog's e-mail communication with the Massachusetts resident was designed to stimulate interest in Bulldog's funds and thus constituted a solicitation of an offer to buy unregistered securities. Bulldog argued that a disclaimer on its website stated that the website did not constitute a solicitation to purchase its investment services or products. However, the court did not find the presence of the disclaimer to be dispositive. "More importantly," said the court, "the e-mail message sent to [the resident] and the attachments therein did not contain the disclaimer that was posted on the Web site."[10]

Hedge funds should be advised to closely monitor e-mail communications with prospective investors, especially when it is unknown whether the investor is financially accredited. Prudent practice also dictates that funds take care to restrict distribution of their promotional materials, as the transmission of such materials stimulating interest in the fund could be viewed as a solicitation of an offer. Finally, hedge funds should make sure that appropriate disclaimers appear on websites, e-mails, and promotional materials.

B. New Developments in Securities Litigation

1. Lawsuits for Alleged Practices in Marketing and Short-Selling Subprime CDOs

Two lawsuits have been filed against Goldman Sachs by hedge funds that invested in subprime collateralized debt obligations ("CDOs") marketed by Goldman Sachs. Both complaints allege that Goldman Sachs sold these CDOs at the same time that it took short positions against the subprime market. The plaintiff hedge funds also allege that Goldman Sachs misled investors about the CDO market. Both lawsuits came in the wake of a U.S. Senate subcommittee investigation addressing related issues. It is expected that these lawsuits will be vigorously defended, but their ultimate outcome – as well as whether they will lead to more similar suits by investors of hedge funds – remains unclear.

a. Basis Yield Alpha Fund (Master) v. Goldman Sachs & Co., Goldman Sachs International and Goldman Sachs JBWere Pty. Ltd.

On June 9, 2010, hedge fund Basis Yield Alpha Fund (Master) ("Basis") filed a civil securities fraud suit against Goldman Sachs in the Southern District of New York.[11] The complaint alleges that defendant marketed the subprime CDO Timberwolf 2007-1 without disclosing that it expected Timberwolf to decline in value and that it was shorting the market for subprime securities. Timberwolf eventually lost 80% of its value, which caused Basis to fold.

b. Dodona I LLC v. Goldman Sachs & Co.

On September 30, 2010, hedge fund Dodona I ("Dodona") filed a complaint in the Southern District of New York alleging that Goldman Sachs created and sold CDOs that were deliberately structured to fail.[12] Dodona claims that at the time it purchased $4 million worth of subprime CDOs, Goldman Sachs failed to disclose that the CDOs were "doomed to lose value" and that Goldman Sachs "would profit enormously from proprietary short positions when the CDOs did lose value." The complaint also compared the CDOs to Abacus 2007-AC1, the mortgage deal involved in the Goldman Sachs civil fraud case brought by securities regulators that resulted in a $550 million settlement.

2. Parkcentral Global, L.P. Compelled to Disclose Its List of Limited Partners

The Delaware Supreme Court affirmed an order of the Chancery Court compelling hedge fund Parkcentral Global, L.P. ("Parkcentral") to disclose its list of limited partners to another limited partner, Brown Investment Management, L.P. ("Brown").[13] Brown followed the fund's procedure for requesting a list of names and addresses for each limited partner shortly after Parkcentral collapsed. Brown sought this list to contact other partners regarding a potential lawsuit against Parkcentral. Parkcentral refused to provide the list, citing its Private Placement Memorandum ("PPM") and investor privacy notices.

The court rejected Parkcentral's basis for withholding the list, explaining that Parkcentral could not unilaterally issue a PPM or privacy notice to eliminate a limited partner's right of access to the partnership list under the Delaware Revised Uniform Limited Partnership Act. If Parkcentral wished to restrict access to the partnership list, the court said, it could have included explicit language to that effect in the partnership agreement. Since the partnership agreement contained no such explicit language, the court affirmed the order of disclosure.

As the ruling suggests, the general rule is that limited partners of a fund are entitled to access the fund's partnership list. If the fund wishes to restrict access to the list, explicit language to that effect must appear in the partnership agreement.

3. Lawsuit Can Proceed Against Fund's Executives and Officers for Role in Ponzi Scheme

On June 10, 2010, the Eastern District of Pennsylvania denied a motion to dismiss claims against the officers and directors of hedge fund MB Investment Partners, Inc. ("MB").[14] Mark Bloom, who was the former President, Co-Managing Partner, Chief Marketing Officer, and director of MB, pled guilty to fraud and money-laundering in 2009. Bloom used his position at MB to attract investors (including plaintiffs) to the Ponzi scheme he was operating. Plaintiffs sued MB and its officers and directors on the basis of "Controlling Person Liability" under the Exchange Act, and the basis of "negligent supervision" under Pennsylvania law for their failure to uncover Bloom's fraud.

The District Court found that the complaint sufficiently stated several causes of action against MB and its directors. It explained that, in order to establish a cause of action for controlling person liability under Section 20(a) of the Exchange Act, the plaintiff need only allege that the defendant controlled another person who committed a violation of the securities laws. The plaintiff need not plead facts demonstrating that the defendant was a culpable participant, although he must eventually prove such facts to succeed at trial. The court also found that the plaintiffs stated a cause of action under Pennsylvania law for negligent supervision by alleging that the MB officers and directors negligently failed to control or monitor Bloom, thereby rendering his fraud foreseeable.

4. Liquidating Trustee of Lipper Convertibles, L.P. Allowed to Claw Back Withdrawals

The New York State Supreme Court ruled that the liquidating trustee of a collapsed hedge fund should be allowed to claw back withdrawals made to investors who withdrew at a time when the fund's net asset value was dramatically overstated due to fraud.[15]

Sylvester Stallone ("Rocky") and several other investors invested in Lipper Convertibles, L.P., a hedge fund formed by Lipper & Company, L.P. From 2001 to 2002, Stallone and the other investors withdrew as limited partners from the fund and received payouts based on the net asset value of the fund at the time. However, a review performed shortly thereafter revealed that the fund's net asset value was overstated due to fraud by the fund's portfolio manager and auditor. The fund's value was then written down to 53 percent of the previous value, causing the fund to collapse and liquidate. The liquidating trustee sought to claw back the withdrawals made to Stallone and the other defendants on the theory that they had been unjustly enriched at the expense of the investors who had not withdrawn.

The court explained that "a party who pays money, under mistake of fact, to one not entitled to it should, in equity and good conscience, be permitted to recover it."[16] It then ruled that the trustee had met his burden and shown that the fund's net asset value was overvalued when the defendants withdrew and that defendants received inflated disbursements from the partnership. According to the court, those facts established the requisite elements of unjust enrichment, and, therefore, claw backs were proper.

5. Pension Fund Unreasonably Relied on Amaranth Advisors LLC's Representations Before Signing Subscription Agreement

On March 15, 2010, the Southern District of New York dismissed a lawsuit brought by the San Diego County Employees Retirement Association ("SDCERA") against hedge fund manager Amaranth Advisors LLC ("Amaranth").[17] The complaint alleged that SDCERA was fraudulently induced to invest in funds managed by Amaranth. The court dismissed every count of SDCERA's complaint (which included counts of securities fraud, common law fraud, and breach of fiduciary duty).

Before SDCERA invested in Amaranth's hedge fund in 2005, several Amaranth officers represented that the fund was a multi-strategy hedge fund that exercised sophisticated risk management controls. However, the fund was really operated as a single-strategy fund that did not use even basic risk management techniques. SDCERA eventually invested $175 million in Amaranth and received a Private Placement Memorandum as part of the subscription agreement. The PPM contained several "General Notices" in all caps, confirming that the investments were speculative, illiquid and risky, and that no one was authorized to make representations concerning the fund other than those in the PPM. The PPM also stated that Amaranth and its managers were not bound to any diversification requirements or risk controls. However, SDCERA alleged that it relied to its detriment on the representations made by Amaranth's officers about the characterization of the fund, which it claimed amounted to securities fraud under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

The court noted that SDCERA was "a sophisticated investor" that employed many professionals to review the specifications of Amaranth's fund. Moreover, SDCERA signed the subscription agreement, thereby acknowledging that it had relied solely on the information contained within the PPM in deciding whether to invest with Amaranth. Given those facts, the court found that SDCERA's purported reliance on statements made before execution of the subscription agreement to be unreasonable as a matter of law.

The SDCERA ruling confirms the importance of the PPM's wording and associated disclaimers in establishing the parameters of the investment and the disclosure of risks to potential investors.

6. Southern District of New York Dismisses Fund's Lawsuit Against Wachovia Bank Regarding Collateral for Credit Default Swap

The Southern District of New York dismissed a lawsuit brought by hedge fund CDO Plus Master Fund Ltd. (now known as VCG Special Opportunities Master Fund Ltd.) ("CDO Plus") against Wachovia Bank, N.A. ("Wachovia"). CDO Plus had alleged that Wachovia breached the implied covenant of good faith and fair dealing when its demands for collateral exceeded the notational value of a credit default swap transaction between the parties.

In May 2007, CDO Plus and Wachovia entered a credit default swap transaction that had a collateralized debt obligation as an underlying reference obligation. Wachovia paid premiums to CDO Plus in exchange for CDO Plus's assumption of the reference obligation's credit risk. If the reference obligation experienced a credit event, CDO Plus was obligated to pay the notational amount of $10 million. The swap agreement also provided that the parties would transfer collateral to each other depending on the fluctuating value of the parties' exposure.

As the credit market deteriorated in 2007, Wachovia made 14 separate demands for additional collateral. CDO Plus acceded to each of these demands. By November 2007, however, after Wachovia solicited quotations to calculate its exposure under the agreement's dispute resolution provision and demanded additional collateral, CDO Plus refused and instead sued Wachovia for breach of the implied covenant of good faith and fair dealing.

Specifically, CDO Plus argued that Wachovia acted arbitrarily and unreasonably by relying on allegedly infirm quotations and by demanding collateral that exceeded the notational amount of the credit swap. The court found no evidence to suggest that the disputed quotations were inaccurate, found that CDO Plus's remaining contentions were inapposite to the breach of covenant claim, and granted Wachovia's motion for summary judgment against CDO Plus.

The crux of CDO Plus's claim was that the manner in which Wachovia's quotations were made was somehow infirm. For example, CDO Plus complained that one quotation was the product of a "quick look" made hastily, yet there was nothing in the agreement that restricted Wachovia from obtaining these kinds of quotations. A more specific dispute resolution provision might have changed the outcome.

7. Lawsuit Against "Sub-feeder" Fund Investing in Bernard L. Madoff Securities LLC Dismissed for Lack of Scienter

The Southern District of New York dismissed a complaint alleging securities fraud against Family Management Corporation ("FMC") for lack of scienter.[18] FMC managed the FM Low Volatility Fund, which was a "sub-feeder" fund that invested in other feeder funds; those feeder funds, in turn, invested with Bernard L. Madoff Securities LLC. Once Madoff's fraud became public, the fund lost a large portion of its investments and eventually dissolved. The plaintiff investors alleged that FMC, interested only in collecting "exorbitant and unique fees and commissions," was willfully blind to red flags that would have led to the discovery of Madoff's fraud. Because FMC did not investigate or disclose the risks of investing with Madoff, the plaintiffs claimed that FMC committed fraud under Section 10(b) of the Exchange Act.

FMC moved to dismiss the Section 10(b) claim on the basis that the plaintiffs did not adequately plead scienter. Section 10(b) claims are subject to the Private Securities Litigation Reform Act ("PSLRA"), which requires plaintiffs to plead particular facts giving rise to a strong inference of scienter. The court ruled that plaintiffs' allegations as to FMC's scienter based on "motive and opportunity to commit fraud" lacked such a factual basis.

First, the court found that the plaintiffs failed to demonstrate that FMC's fees were exorbitant or in excess of the industry standard, thus undermining the inference that FMC benefited from Madoff's fraud. Second, the court found that the red flags that FMC allegedly should have noticed were not "extremely obvious," especially in light of the fact that Madoff operated his Ponzi scheme for twenty years without being discovered. Because the factual record did not support an inference of scienter, the court dismissed the Section 10(b) claim.

8. Investor in Camulos Partners Not Permitted to Petition for Liquidation in Order to Redeem Shares

The Cayman Islands Court of Appeal ruled that a hedge fund investor may not petition for liquidation in order to pressure the fund to pay out a redemption demand when the investor has other alternatives to seek payment of its claim.[19] Kathrein & Co. ("Kathrein"), an investor in Camulos Partners Offshore Limited, requested redemption of its entire interest in the fund, but the fund shortly thereafter announced a plan of reorganization and suspended all redemptions. In response, Kathrein filed a winding-up petition in order to force liquidation of the fund.

The court ruled that there was an alternative and more suitable remedy available to Kathrein – the ordinary civil litigation process – and that Kathrein had acted unreasonably by pursuing the winding-up petition instead. Filing a winding-up petition could interfere with the rights of innocent shareholders. The court also warned that it was improper for an investor to threaten liquidation in order to pressure the fund to accede to its demands.

IV. REGULATORY ENFORCEMENT

As we head into the final quarter of 2010, the SEC will continue to gain momentum in its execution of its regulation and enforcement initiatives, many of which affect and even target the hedge fund industry. Last year, the SEC restructured its Division of Enforcement and streamlined its procedures in an attempt to improve its effectiveness.[20] In particular, the Division of Enforcement was divided into five specialized units, including the Asset Management Unit, which was created to focus on investment companies, investment advisers, mutual funds, private equity funds and hedge funds. The new Asset Management Unit is now fully operational and has actively been investigating issues involving hedge funds and investment advisers throughout this year. Armed with new powers from the landmark Dodd-Frank Act, and with increased funding for the SEC, we anticipate that the Asset Management Unit will aggressively investigate the hedge fund industry and bring a wide variety of enforcement actions.

Hedge funds will undoubtedly feel the continued impact of this heightened scrutiny, as they will be required to devote additional time and attention to monitoring compliance with new regulatory and reporting obligations and managing a likely increase in inquiries from regulators and investors alike. For instance, as discussed in Section I of this report, many investment advisers that formerly relied on an exemption from registration will soon be required under the Dodd-Frank Act to register with the SEC, subjecting these advisers to SEC audits and compliance exams.[21] Moreover, through a new whistleblower program, the Dodd-Frank Act now incentivizes hedge fund employees and other individuals to come forward with evidence of wrongdoing, which inevitably will also lead to more SEC exams and investigations.[22] These and other new SEC enforcement powers ensure that an intense regulatory and enforcement focus will remain on hedge funds. Below are key enforcement highlights from the Dodd-Frank Act, along with an examination of several instructive recent enforcement actions and an update on another recent area of SEC interest, funds-of-funds.

A. Enforcement Highlights From the Dodd-Frank Act

1. Administrative Penalties

Section 929P(a) of the Dodd-Frank Act now permits the SEC to obtain monetary penalties in administrative proceedings from any person or entity that violates the federal securities laws. Previously, the SEC could only obtain monetary penalties in administrative cease-and-desist proceedings if the respondent was a regulated entity (*e.g.*, a broker-dealer or investment adviser). This will likely incentivize the SEC to bring more actions in the administrative arena since, unlike federal court cases, administrative proceedings are less formal and the rules of evidence are relaxed. In addition, administrative proceedings are more streamlined and can be brought to a conclusion quicker, which both the SEC and most respondents prefer.

2. Extraterritorial Jurisdiction

The Dodd-Frank Act also significantly expands the jurisdiction of the SEC by providing that federal courts shall have jurisdiction over any action or proceeding brought by the SEC or the United States as long as it alleges "(1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States."[23] In short, for jurisdictional purposes, all the SEC must allege and show is that the purported conduct at issue occurred in the United States and comprised "significant steps" of the alleged violation; or, for conduct outside the United States, that the conduct would have a "foreseeable substantial effect" within the United States borders. This jurisdictional expansion ensures that the SEC can continue to investigate and prosecute fraudulent activity in financial markets in many instances even if the conduct or transaction occurred outside the United States or only implicates foreign investors. Undoubtedly, there will be litigation over the contours of what U.S. conduct qualifies as "significant steps" and what foreign conduct qualifies as having a "foreseeable and substantial effect" within the United States, but the Dodd-Frank Act leaves no uncertainty as to Congress's desire to empower the SEC to pursue fraudulent conduct irrespective of where it occurs.

3. Nationwide Subpoena Power

Another manner in which the Dodd-Frank Act increases the SEC's reach is by providing nationwide subpoena power.[24] Under Section 929E, parties in federal court litigation initiated by the SEC may issue subpoenas to compel witnesses located anywhere in the United States to appear at hearings or trials. Previously, potential hearing and trial witnesses who did not live within the federal judicial district (or within 100 miles of the district) where the proceeding was located could not be compelled to appear in person at trial. In these situations, depositions of the witnesses were commonly used as trial testimony. As a result of the Dodd-Frank Act, a party in an SEC litigation can now compel a witness to show up at court and provide hearing or trial testimony by simply issuing and serving a trial subpoena on that person while they are present within the United States.

4. Aiding and Abetting

The Dodd-Frank Act also expands the SEC's enforcement powers with respect to "aiding and abetting" claims.[25] In particular, Sections 929M-O authorize the SEC to bring charges against "any person that knowingly or recklessly provides substantial assistance to another person" in violation of the federal securities laws. Prior to the Dodd-Frank Act, liability was only imposed on a person who "knowingly" provided substantial assistance. This relaxed standard may make it easier for the SEC to successfully bring aiding and abetting claims and may result in more aggressive charging decisions. Similarly, Section 929P(c) of the Dodd-Frank Act clarifies who can bring "control person liability" claims under Section 20(a) of the Exchange Act. Prior to the Dodd-Frank Act, some had questioned whether Section 20(a) claims were limited to private plaintiffs. The Dodd-Frank Act now clarifies that the SEC has the ability to charge so-called "control persons," persons who directly or indirectly control a primary violator.

5. Whistleblower Program

The Dodd-Frank Act also created a new whistleblower program. The Dodd-Frank Act defines a "whistleblower" as "any individual who provides . . . information relating to a violation of the securities law to the Commission, in a manner established, by rule or regulation, by the Commission."[26] A whistleblower *shall* be paid an award if he or she "voluntarily provided original information to the Commission that led to the successful enforcement of the covered judicial or administrative action, or related action." To qualify as "original information," the material must (1) be derived from the independent knowledge of the whistleblower, (2) must not be known to the SEC from any other source, and (3) must not be "exclusively derived" from an allegation made elsewhere, "unless the whistleblower is a source of the information." Additionally, a whistleblower cannot receive an award if he or she is convicted of a criminal violation in connection with the alleged wrongful activity. If a whistleblower qualifies for an award, then he or she shall be entitled to an award of between 10% and 30% of the monetary sanctions imposed in the action, as long as the monetary sanctions are in excess of $1 million. The law also prohibits employer retaliation against the whistleblower and permits the whistleblower to bring a private cause of action if he or she is discriminated against on the basis of cooperating with the SEC.[27]

With this framework in place, the Dodd-Frank Act now crystallizes the potentially enormous monetary benefits a whistleblower may realize. Since many enforcement actions result in the payment of tens of millions of dollars, if not more, in monetary penalties, employees will be strongly motivated to come forward to the SEC with evidence of wrongdoing. One area of uncertainty is how stringent the SEC will be in applying the "original information" standard when determining whether a whistleblower is entitled to an award. Nevertheless, given the current political and economic realities, companies can very well expect increased regulatory inquiries that stem from employee reporting.

B. Recent Enforcement Actions

The last six months have seen a steady stream of SEC enforcement actions involving hedge funds and investment advisers. These actions run the gamut from insider trading and short selling to unlawful marketing and misrepresentations to investors. One overarching lesson from these cases is that, given the challenging regulatory environment in which hedge funds find themselves, they must be especially vigilant in updating and executing their internal policies and procedures. At least some of the actions below could have potentially been avoided.

1. Short Selling

On September 23, 2010, in *In the Matter of Carlson Capital, L.P.*,[28] a hedge fund adviser agreed to pay more than $2.6 million to settle charges that it had improperly participated in four secondary public stock offerings after selling short those same stocks. Under Rule 105 of Regulation M of the Exchange Act, it is "unlawful for any person to sell short . . . the security that is the subject of the offering and purchase the offered securities from an underwriter or broker or dealer participating in the offering if such short sale was effected . . . [b]eginning five business days before the pricing of the offered securities and ending with such pricing."[29] . . . The restriction is designed to prevent short selling that can artificially depress the market price of a stock before the company prices its public offering. The SEC's Order found that the hedge fund adviser violated Rule 105 on four separate occasions and had inadequate policies and procedures in place to prevent the firm from short selling prior to the offerings in which it participated.

On one of the occasions at issue, the SEC found a Rule 105 violation even though different portfolio managers short sold and bought the stock. Although Rule 105 subsection (b)(2) provides a "separate accounts" exception to short selling restrictions, the SEC concluded that it did not apply. To qualify for the exception, the short selling during the five-day period prior to pricing and the buying of the stock in the offering must occur in separate accounts, and decisions regarding securities transactions for each account must be made separately and without coordination of trading or cooperation among or between the accounts.[30] The SEC found that the hedge fund adviser did not qualify for this exception because the managers (1) could access each other's account reports, trade positions, and other relevant information; (2) reported to a single chief investment officer who had authority over the firm's positions; and (3) could coordinate with each other with respect to trading. The SEC also found that the portfolio manager who sold short the stock during the five-day period had learned prior to short selling that the other portfolio manager intended to buy offering shares.

2. <u>*Insider Trading*</u>

In *SEC v. David R. Slaine*,[31] the SEC recently obtained a final judgment relating to an insider trading case the SEC filed on February 2, 2010. In that case, Slaine, a former hedge fund manager, was charged with using material nonpublic information obtained from a former investment bank employee to trade ahead of the public announcement of a bank analyst's recommendations. The insider trades were made in the hedge fund's and Slaine's personal accounts. Slaine agreed to disgorge $836,385 in profits and also consented in a related SEC administrative proceeding to an order barring him from associating with any other investment advisers. Slaine also pled guilty to related criminal charges. No civil penalties were imposed because of Slaine's cooperation with the SEC. Other defendants, including the hedge fund adviser, previously entered into settlements with the SEC relating to the same insider trading scheme.

In *SEC v. James W. Self, Jr. and Stephen Goldfield*,[32] the SEC recently settled a case of insider trading against Self, an Executive Director of Business Development at a pharmaceutical company, and Goldfield, a former hedge fund manager. The SEC alleged that Self provided Goldfield with material nonpublic information relating to a potential acquisition. Goldfield, in turn, purchased call options and shares of the target company's stock, realizing profits of $14 million in the process. The following month, Goldfield lost all of the money trading index options. Goldfield consented to a permanent injunction against future violations of Section 10(b) of the Exchange Act and Rule 10(b)(5) promulgated thereunder, and agreed to disgorge $13,978,752 in profits and to pay $2,666,275 in prejudgment interest. Payment of all but $600,000 was waived due to the financial condition of Goldfield.

In *SEC v. Pequot Capital Management, Inc. et al.*,[33] this past May the SEC brought and settled a civil enforcement action against Pequot Capital Management, Inc., the well-known hedge fund, and its Chairman and CEO, concerning insider trading in Microsoft securities. According to the SEC's complaint, a former Microsoft employee who had recently joined the hedge fund obtained positive quarterly earnings guidance for Microsoft from a current Microsoft employee. Armed with that inside information, the hedge fund traded in Microsoft securities, netting more than $14 million in profits. The hedge fund and its Chairman agreed to disgorge $15,142,020 in profits on a joint and several basis and to pay a civil penalty of $5 million each and prejudgment interest in the amount of $2,696,448.[34] Notably, the SEC announced in connection with the settlement that it paid an award of $1 million to a Connecticut couple who provided "information and documents leading to the imposition and collection of civil penalties" in the matter. This is the largest award paid to date by the SEC for information provided in connection with an insider trading case.

3. <u>*PIPE Transactions*</u>

Regulatory agencies, including the SEC, have always had a strong interest in Private Investments in Public Equities ("PIPEs"). In particular, the SEC has focused on PIPEs involving the sale of variable-priced securities and short selling in advance of offerings. This will continue to be an area of interest for the SEC and can lead to enforcement actions against those who run afoul of the rules. For example, in *SEC v. Robert A. Berlacher, et al.*,[35] a federal court recently found that a hedge fund manager, along with several investment advisers and hedge funds he managed, were liable for securities fraud in connection with PIPE transactions. The SEC alleged that the defendants sold the issuer's stock short after learning about the timing of the PIPE offering. After the offering, and after the resale registration statement became effective, the defendants used the PIPE shares to cover their short positions. It was alleged that the defendants undertook a variety of techniques to avoid detection, such as engaging in wash sales and pre-arranged trades, to make it appear that they were covering their short positions with shares obtained in the open market. According to the SEC, the defendants also made false representations to the PIPE issuers when they represented that they would not sell, transfer, or dispose of the PIPE shares other than in compliance with applicable laws, and that they did not hold a short position in the securities at the time they signed a stock purchase agreement when, in fact, they did. As a result of these material misrepresentations, the court found that the defendants violated Section 10(b) and Rule 10b-5. The court, however, found that the SEC had failed to demonstrate that the defendants engaged in insider trading.

4. *Misrepresentations of Investment Suitability*

On September 7, 2010, in *In the Matter of Neal R. Greenberg*,[36] the SEC charged Greenberg, an investment adviser, with fraud and breach of fiduciary duty in the marketing and recommendation of his firm's hedge funds to elderly investors. The SEC alleged that the adviser promoted his hedge funds as suitable for conservative investors who were retired or nearing retirement, when in fact the funds were highly leveraged and concentrated in a small number of investments. In particular, the SEC alleged that the misrepresentations included telling investors that the funds offered liquidity, immense diversification and minimal risk, when, in fact, the funds offered none of the above and were contradicted by the private placement memoranda. The SEC further alleged that the hedge funds improperly collected approximately $2 million in management and performance investment fees that were not adequately disclosed to investors and that the fund failed to institute adequate compliance policies and procedures to determine what complex hedge fund products were suitable for investors. The matter is still ongoing.

5. *Inappropriate Investment Strategy*

In *SEC v. Thompson Consulting, Inc.*,[37] a district court in Utah entered final judgments of injunctive relief and disgorgement on August 17, 2010 against Thompson Consulting, a hedge fund adviser, and other individuals or related companies for violations of Sections 17(a)(2) and (3) of the Exchange Act and Section 206(2) of the Advisers Act. The SEC alleged that the hedge fund adviser violated the anti-fraud provisions by making undisclosed subprime and other high-risk investments in two hedge funds that resulted in almost a complete asset loss. The hedge fund adviser was also accused of deviating from the funds' stated investment policy, resulting in substantial losses. In addition to the injunctive relief, Thompson Consulting agreed to disgorge $400,000 in profits. The defendants consented to the entry of the final judgments without admitting or denying the allegations of the complaint.

6. *Side Pockets and Valuation*

On October 19, 2010, in *SEC v. Mannion et al.*,[38] the SEC brought suit against PEF Advisors LLC and hedge fund managers Paul Mannion, Jr. and Andrew Reckles for allegedly committing securities fraud by improperly overvaluing fund assets held in a "side pocket," and for allegedly making material misrepresentations in connection with a PIPE offering. In its suit, the SEC claims that the defendants invested more than 20% of Palisades Master Fund, L.P.'s assets in World Health Alternatives, Inc. ("World Health"), a now-bankrupt medical staffing company. According to the SEC, the defendants were concerned that, if news of World Health's increasingly precarious financial situation became public, large numbers of investors in the hedge fund would seek to redeem their investments, thereby causing the fund's collapse. The defendants decided to place the investment in World Health in a "side pocket." According to the SEC, the defendants allegedly assigned a value to the World Health securities, which value was substantially higher than their own internal valuation assessment of the securities.[39] The SEC also alleged that the defendants attempted to, but were unable to, obtain a third-party valuation. The SEC alleges that the defendants reported misleadingly inflated net asset values of the fund to investors, which, in turn, permitted the defendants to take excessive management fees. The defendants are also alleged to have traded on material, nonpublic information regarding a PIPE offering by Radyne ComStream Inc., despite their knowledge that the Radyne PIPE was confidential and despite their agreement not to trade on the nonpublic information.

C. SEC Sweep Exam – Funds-of-Funds

According to recent news reports, the SEC is examining whether funds that collect fees for directing investors into other hedge funds are acting in their clients' best interests.[40] One of the SEC's broadest examinations of hedge funds ever, according to news reports, the sweep exam may cast a long shadow on the hedge fund industry for many months to come as the SEC heightens its regulatory enforcement.[41] Reportedly targeting firms overseeing $100 million to $15 billion in assets, the SEC's aim is to examine whether the firms have conflicts of interest preventing them from offering the best funds to their clients and/or whether there was trading by executives of those firms in front of client orders or in a manner that bet against clients. As part of the sweep exam, the SEC is collecting from the funds-of-funds the names of hedge funds that the funds-of-funds advisers considered, but ultimately rejected, along with the reasons as to why those funds were not selected. The SEC is also asking for the names of consultants and outside advisers that helped select or reject managers, and how much they were paid. Hedge funds and their advisers should be prepared for inquiries from the SEC that may stem from this recent initiative, even if the fund was not initially a target of the sweep exam.

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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] Under the Dodd-Frank Act, a "Foreign Private Adviser" is defined as an investment adviser that (a) does not have a place of business in the United States; (b) has, in the aggregate, fewer than 15 clients and investors in the United States in any Private Fund it advises; (c) has aggregate AUM attributable to U.S. clients and U.S. investors in any Private Funds it advises of less than $25 million or such higher amount as the SEC may, by rule, deem appropriate; and (d) does not hold itself out generally to the public in the United States as an investment adviser, or act as an investment adviser to any registered investment company or business development company.

[3] The Dodd-Frank Act does not define the term "Venture Capital Fund" but requires the SEC to define such term by July 20, 2011.

[4] Under the Dodd-Frank Act, the term "Banking Entity" is defined as any insured depository institution, any company that controls an insured depository institution or is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978 and any affiliate or subsidiary of any such entity.

[5] For purposes of the Volcker Rule, the term "Private Fund" covers entities that rely on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act to be exempted from registration as an investment company. The Dodd-Frank Act, however, authorizes applicable regulatory agencies to adopt rules to expand the definition of "Private Fund" to include other entities.

[6] *The Pension Comm. of the Univ. of Montreal Pension Plan, et al. v. Banc of America Securities, LLC, Citco Fund Services (Curacao) N.V., The Citgo Group Ltd., Int'l Fund Services (Ireland) Ltd., PricewaterhouseCoopers (Netherland Antilles), John W. Bendall, Jr., Richard Geist, Anthony Stocks, Kieran Conroy, and Declan Quilligan*, No. 05 Civ. 9016 (SAS) (S.D.N.Y. Feb. 16, 2010).

[7] 15 U.S.C. § 77p(f)(3).

[8] *Bulldog Investors General Partnership et al. v. William F. Galvin, Secretary of the Commonwealth,* Civil Action No. 07-1261-BLS2.

[9] 457 Mass. 210 (2010).

[10] *Id.* at 221.

[11] *Basis Yield Alpha Fund (Master) v. Goldman Sachs Group, Inc., Goldman Sachs & Company, Goldman Sachs International and Goldman Sachs JBWere Pty. Ltd.,* Case No. 10 Civ. 04537 (S.D.N.Y. June 9, 2010).

[12] *Dodona I LLC v. Goldman Sachs & Co.*, S.D.N.Y., 10-7497 (October 1, 2010).

[13] *Parkcentral Global, L.P. v. Brown Investment Management, L.P.,* 2010 WL 3178430 (Del. Aug. 12, 2010).

[14] *Belmont et al. v. MB Investment Partners, Inc. et al.*, Civil Action No. 09-4951, (E.D. Pa. June 10, 2010).

[15] *Richard A. Williamson v. Sylvester Stallone, Ehud Shapiro et al.,* 905 N.Y.S.2d 740 (N.Y. Sup. Ct. April 30, 2010).

[16] *Id.* at 746-47.

[17] *San Diego County Employees Retirement Association v. Nicholas Maounis, Charles Winkler, Robert Jones, Brian Hunter and Amaranth Advisors LLC,* 07-CV-2618 (S.D.N.Y. Mar. 15, 2010).

[18] *Newman v. Family Management Corporation*, 08-CV-11215 (S.D.N.Y. Oct. 20, 2010).

[19] *In re Camulos Partners Offshore Limited*, Cayman Islands Court of Appeal (March 18, 2010).

[20] *See* Robert Khuzami, Director, SEC Enforcement Division, "Remarks at News Conference Announcing Enforcement Cooperation Initiative and New Senior Leaders," Jan. 13, 2010, Washington, D.C.

[21] *Id.* § 403.

[22] *Id.* § 922.

[23] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 929P(b).

[24] *Id.* § 929E.

[25] *Id.* §§ 929M–O.

[26] *Id.* § 922.

[27] *Id.*

[28] SEC Release No. 2010-172, "SEC Charges Dallas-Based Hedge Fund Adviser for Participating in Stock Offerings After Selling Short" (Sept. 23, 2010), http://www.sec.gov/news/press/2010/2010-172.htm.

[29] 17 C.F.R. § 242.105(a).

[30] 17 C.F.R. § 242.105(b)(2).

[31] SEC Litig. Release No. 21653 (Sept. 16, 2010), http://www.sec.gov/litigation/litreleases/2010/lr21653.htm.

[32] SEC Litig. Release No. 21638 (Sept. 1, 2010), http://www.sec.gov/litigation/litreleases/2010/lr21638.htm.

[33] SEC Release No. 2010-88, "SEC Charges Pequot Capital Management and CEO Arthur Samberg With Insider Trading" (May 27, 2010), http://www.sec.gov/news/press/2010/2010-88.htm.

[34] SEC Investment Advisers Act of 1940 Release No. 3035 (June 8, 2010), http://www.sec.gov/litigation/admin/2010/ia-3035.pdf.

[35] No. Civ. A. 07-3800 (E.D. Pa. Sept. 13, 2010); *see also* SEC Litig. Release No. 21648 (Sept. 14, 2010), http://www.sec.gov/litigation/litreleases/2010/lr21648.htm.

[36] Securities Act of 1933 Release No. 9139, Sept. 7, 2010.

[37] SEC Litig. Release No. 21628 (Aug. 18, 2010), http://www.sec.gov/litigation/litreleases/2010/lr21628.htm.

[38] The civil case is *SEC v. Mannion et al.*, No. 10-3374, in the U.S. District Court for the Northern District of Georgia.

[39] SEC Litig. Release No. 21699 (Oct. 19, 2010), http://www.sec.gov/litigation/litreleases/2010/lr21699.htm.

[40] Jenny Strasburg, "SEC Examines Funds of Hedge Funds," *The Wall Street Journal* (Sept. 10, 2010), *available at* http://online.wsj.com/article/SB10001424052748703960004575482190594910322.html.

[41] *Id.*