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PAUL HASTINGS

March 2012

Hedge Fund Report - Summary of Key Developments - Spring 2012

BY THE INVESTMENT MANAGEMENT, SECURITIES LITIGATION & TAX PRACTICES

This continues to be a time of rapid change for the hedge fund industry, as the Securities and Exchange Commission (the "SEC"), the Commodity Futures Trading Commission (the "CFTC"), and various other regulatory agencies, including the Federal Reserve Board (the "Federal Reserve") and the Department of the Treasury (the "Treasury"), continue to propose and finalize rules to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). There have also been a number of significant developments in the hedge fund tax area, and the SEC and private plaintiffs have continued to bring enforcement actions and litigation involving hedge funds and other types of private investment funds and fund managers.

This Report provides an update since our last Hedge Fund Report in November 2011 and highlights recent regulatory and tax developments, as well as recent civil litigation and enforcement actions as they relate to the hedge fund industry. Paul Hastings attorneys are available to answer your questions on these and any other developments affecting hedge funds and their investors and advisers.

I. SECURITIES-RELATED LEGISLATION AND REGULATION

A. Dodd-Frank Rulemaking

The following is the status of various proposed and final rules and regulations implementing the Dodd-Frank Act that are most relevant to the hedge fund industry.

1. SEC and other Financial Regulators' Extension of the Comment Period on the Jointly Proposed Volcker Rule

On December 23, 2011, the SEC, jointly with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Reserve (collectively, the "Agencies") issued a notice extending the comment period for their jointly proposed rule implementing Section 619 of the Dodd-Frank Act, also known as the "Volcker Rule." On February 14, 2012, the CFTC also issued a proposal for implementing the Volcker Rule separate from the Agencies which adopts the entire text of the Agencies' proposed rule and adds additional CFTC-specific rule text. More information on the CFTC's proposed rule is available **here**. The Volcker Rule generally prohibits a banking entity from (i) engaging in short-term proprietary trading of any security, derivative, and certain other financial instruments for the banking entity's own account; or (ii) owning, sponsoring, or having certain relationships with a hedge fund or private equity fund. The Agencies received more than 14,000 comments since they proposed the rule implementing the Volcker Rule on October 12, 2011. The proposed regulations have garnered significant criticism from the financial industry, primarily on the grounds that the Rule is overbroad and would reduce liquidity in the markets. Due to the complexity of the issues involved and to facilitate coordination of the rulemaking among the Agencies, the Agencies extended the comment period 30 days until February 13, 2012. The deadline for comments on the CFTC's proposed Volcker Rule is April 16, 2012. Additional information on the Agencies' proposed regulations implementing the Volcker Rule is available **here**.

2. SEC's Final Rule Amending Definition of "Qualified Client"

On February 15, 2012, the SEC adopted its final rule codifying its final order of July 12, 2011 increasing the dollar thresholds of the assets under management and net worth tests in the definition of "qualified client" in Rule 205-3 under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). On that same date, the SEC also adopted final rules amending Rule 205-3 to (i) provide that the SEC will adjust the dollar amount tests for inflation on a five-year basis (as required by the Dodd-Frank Act), (ii) exclude the value of a person's primary residence from the net worth test, and (iii) add certain transition provisions to Rule 205-3. As amended, the assets under management threshold for qualified clients is $1 million (up from $750,000) and the net worth threshold for qualified clients is $2 million (up from $1.5 million). The revised dollar amounts, which took effect on September 19, 2011, reflect inflation from 1998 to the end of 2010. The first scheduled adjustment to the dollar amount thresholds will take place in 2016. The final rule adopts certain

transition provisions, which ensure that the heightened standards for performance fee arrangements apply only to new contractual arrangements, substantially as proposed, and adds an additional provision to allow for limited transfers of interest (*e.g.*, by gift or bequest, or pursuant to an agreement related to a legal separation or divorce) from a qualified client to a person that was not a party to the contract and is not a qualified client at the time of the transfer. The final rule differs from the proposed rule regarding the primary residence exclusion in one respect: under the final rule, any increase in the amount of debt secured by the primary residence in the 60 days before the advisory contract is entered into will be included as a liability. This change is intended to prevent debt that is incurred shortly before entry into an advisory contract from being excluded from the calculation of net worth merely because it is secured by the individual client's home. The final rule, including the primary residence exclusion and transition provisions, will become effective on May 22, 2012. Additional information on the SEC's final rule amending the definition of "qualified client" under the Advisers Act is available **here**.

3. SEC's Final Rule Revising Definition of "Accredited Investor"

On December 21, 2011, the SEC adopted final amendments to its rules to exclude the value of a person's home from the net worth calculation used to determine whether an individual may invest in certain unregistered securities offerings. The amended rule codifies changes to the definition of "accredited investor" under the Securities Act of 1933, as amended (the "Securities Act"), made effective upon the passage of the Dodd-Frank Act. The final rule differs from the rule proposed by the SEC on January 25, 2011 in three respects: the final rule (i) includes transition provisions which permit the application of the former net worth test for an accredited investor in certain limited circumstances, (ii) treats certain indebtedness secured by the person's primary residence in the 60 days prior to the sale of securities to that individual as a liability, and (iii) clarifies the language of the proposed rule to make the rule easier to apply. The amended net worth standard became effective on February 27, 2012. The Dodd-Frank Act requires that the SEC review the "accredited investor" standard in its entirety in 2014 and every four years thereafter, and engage in further rulemaking to the extent that it deems appropriate. Additional information on the SEC's final rule revising the definition of "accredited investor" under the Securities Act is available **here**.

4. SEC's and CFTC's Joint Report on International Swap Regulation

On February 1, 2012, the SEC and the CFTC released their Joint Report on International Swap Regulation (the "Joint Report"), as mandated by Section 719(c) of the Dodd-Frank Act. Section 719(c) of the Dodd-Frank Act directs the SEC and the CFTC to study the regulation of swaps, clearinghouses, and clearing agencies in the United States, Europe, and Asia, and to determine similarities and opportunities for harmonizing the regulatory regimes. The Joint Report concluded that it is too early to identify whether there is international alignment in the regulation of over-the-counter ("OTC") derivatives. The Joint Report also provided recommendations for how the SEC and the CFTC can ensure continued compliance with Section 752(a) of the Dodd-Frank Act, which requires the SEC and the CFTC, as appropriate, to consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards for regulating swaps and swaps entities. The Joint Report recommends that the SEC and the CFTC continue to (i) monitor developments at the national level across jurisdictions, (ii) communicate with fellow regulators involved in efforts to regulate OTC derivatives, (iii) participate in international fora and actively contribute to initiatives designed to develop and establish global standards for OTC derivatives regulation, and (iv) engage in bilateral dialogues with regulatory staff in the European Union, Japan, Hong Kong, Singapore, Canada, and additional jurisdictions, as appropriate. The full text of the Joint Report is available **here**.

5. SEC's No-Action Letter on Registration of Certain Entities Related to SEC-Registered Investment Advisers

On January 18, 2012, the SEC issued a no-action letter (the "2012 Letter") on various issues regarding the registration with the SEC of certain entities related to SEC-registered investment advisers. The 2012 Letter reaffirms and clarifies the SEC's position on circumstances under which certain special purpose vehicles ("SPVs") and certain other advisory or management entities that are related to an SEC-registered investment adviser may satisfy their obligation to register as investment advisers with the SEC through the registration of their related registered adviser.

In a December 8, 2005 letter addressed to the American Bar Association's Subcommittee on Private Investment Entities (the "2005 Letter"),[1] the SEC stated that it would not require the registration of an SPV established by a private fund to act as the private fund's general partner or managing member if certain conditions where met. The 2012 Letter (i) affirmed the continuing validity of the 2005 Letter following the Dodd-Frank Act's repeal of the private adviser exemption under the Advisers Act; (ii) confirmed that the 2005 Letter applies to registered advisers with multiple SPVs; and (iii) expanded the scope of the 2005 Letter to SPVs with independent directors, provided that such independent directors are the only persons acting on behalf of the SPV who are not "persons associated with" the registered adviser (as defined in Section 202(a)(17) of the Advisers Act).

Advisers to a private fund may be part of a group of related advisers for operational, tax, regulatory, or other reasons. The 2012 Letter also addressed the circumstances under which related advisers that are not SPVs (the "relying advisers") could rely on the registration of a single "filing adviser" in lieu of registering separately with the SEC. The 2012 Letter stated that the SEC would not require relying advisers to file separately from the filing adviser if the filing adviser and each relying adviser collectively conduct a "single advisory business." Under the 2012 Letter, the SEC would view the filing adviser and one or more relying advisers as a single advisory business if (i) the filing adviser and each relying adviser advise only private funds and separate account clients that are qualified clients (as defined in Rule 205-3 under the Advisers Act) and are otherwise eligible to invest in the private funds advised by the filing adviser or a relying adviser and whose accounts pursue investment objectives and strategies that are substantially similar or otherwise related to those private funds; (ii) each relying adviser, its employees and the persons acting on its behalf are "persons associated with" the filing adviser; (iii) the filing adviser has its principal office and place of business in the United States; (iv) the advisory activities of each relying adviser are subject to the Advisers Act, and each relying adviser is subject to examination by the SEC; (v) the filing adviser and each relying adviser operate under a single code of ethics adopted in accordance with Rule 204A-1 under the Advisers Act, and a single set of written policies and procedures adopted and implemented in accordance with Rule 206(4)-(7) under the Advisers Act and administered by a single chief compliance officer; and (vi) the filing adviser identifies each relying adviser in its Form ADV and discloses that it and its relying advisers are together filing a single Form ADV in reliance of the position expressed in the 2012 Letter. Private equity and real estate advisers with multiple advisory and management affiliates should review the 2012 Letter to determine whether they and their affiliates can be considered a "single advisory business" entitled to rely on the registration of a single filing adviser. Additional information on the SEC's No-Action Letter is available **here**.

6. House Members' Letter Urging the SEC to Delay the Registration Deadline for Exempt Advisers to Private Equity Funds

On January 30, 2012, a bipartisan group of twenty-seven Members of the House of Representatives (the "Members") submitted a letter to SEC Chairwoman Mary Schapiro urging the SEC to delay the March 30, 2012 implementation of the Dodd-Frank Act's private equity fund adviser registration requirements, and to use its exemptive authority to exclude managers of private equity funds that are not highly leveraged at the fund level from the registration requirements. According to the Members,

the SEC's "registration requirements do not sufficiently consider the nature of private equity funds and the significant differences between private equity and other types of private investment pools." The Members believe that private equity plays a key role in the country's economic recovery and that "[s]ubjecting private equity firms to excessive regulation risk is hindering our nation's economic growth." A copy of the letter is available **here**.

7. Director of SEC's Office of Compliance Inspections and Examinations Outlines Plan for Oversight of Private Fund Advisers

On March 9, 2012, Carlo di Florio, director of the SEC's Office of Compliance Inspections and Examinations ("OCIE"), addressed how OCIE plans to address its new role in the oversight of private fund advisers recently made subject to registration and reporting with the SEC under the Dodd-Frank Act. The statements were made at a conference organized by the Investment Adviser Association in Washington, D.C., and Mr. di Florio stated that he was expressing his own opinions, not necessarily reflecting those of the SEC or its staff. According to Mr. di Florio, OCIE will focus on providing guidance and conducting targeted examinations of private fund advisers. The guidance will highlight OCIE's expectations as well as effective practices for compliance with the new regulatory requirements. The targeted examinations will focus on what OCIE believes are the key compliance risks facing new registrants, including (among others) fiduciary responsibilities, due diligence practices, "classic" fraud indicators such as aberrational performance, insider trading and front running, and preferential treatment (and related conflicts of interest). According to Mr. di Florio, OCIE intends to focus its examinations on boards and senior management of private fund advisers to ensure that upper management is setting the right tone for compliance. OCIE also intends to engage internal audit personnel, portfolio managers, traders, and front-line business managers to understand "how risk is governed and managed in the firm." Mr. di Florio does not expect the national examination manual for private fund advisers, modeled after the SEC's enforcement manual, to be made public until next year.

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

1. CFTC's Final Revisions to the CPO and CTA Registration and Reporting Requirements

On February 9, 2012, the CFTC adopted final amendments to its rules relating to commodity pool operators ("CPOs") and commodity trading advisors ("CTAs") that, among others, rescinds CFTC Regulation 4.13(a)(4), the CFTC exemption from CPO registration commonly relied upon by certain private fund advisers and hedge fund managers. Currently, CFTC Regulation 4.13(a)(4) exempts from CPO registration operators of commodity pools that restrict participation to certain sophisticated investors if certain conditions are satisfied. The final rule retains (with slight modification) the *de minimis* exemption under Rule 4.13(a)(3), which the CFTC had proposed rescinding. Rule 4.13(a)(3) provides an exemption from CPO registration for operators of commodity pools that have limited futures activity. The revised Rule 4.13(a)(3) will include swaps in the threshold calculation for whether an entity qualifies under the *de minimis* exemption, pending finalization by the CFTC of the definition of "swap." In addition, the amended rules now include a requirement that any CPOs or CTAs utilizing the Rule 4.13(a)(3) exemption file an annual notice reaffirming their claims of exemption or exclusion from registration. The amended rules will become effective on April 24, 2012 (the "Effective Amendment Date").

Private fund advisers that are relying on Rule 4.13(a)(4) to avoid CPO registration before the Effective Amendment Date and that have filed the requisite notice with the National Futures Association as of that date will have until December 31, 2012 to identify another exemption or, alternatively, register with the CFTC as CPOs. CPO registration would impose additional financial, disclosure and compliance obligations on advisers and may affect the relevant exemptions or exclusions on which they may rely for the purposes of avoiding registration as a CTA. Advisers should use the transition period to review

their use of futures, options, derivatives and swaps, and consider the best future course of action. Additional information on the CFTC's final rules is available **here**.

2. House's Approval and Senate's and SEC's Consideration of Repeal of Ban on General Solicitation and Advertising by Hedge Funds

On November 3, 2011, the House of Representatives (the "House") passed H.R. 2940, the Access to Capital for Jobs Creators Act. The bill, introduced on September 15, 2011, would require the SEC to eliminate the prohibition on general solicitation or general advertising under Rule 506 of Regulation D under the Securities Act, provided that all purchasers of the securities are accredited investors. Rule 506 is utilized by many private funds as a "safe harbor" from the registration requirements of Section 5 of the Securities Act, and allows a private fund to sell an unlimited dollar amount of fund interests if the conditions to the rule are satisfied. Rule 506 currently prevents funds utilizing the rule from using advertisements or general solicitation activities to market securities to investors. On November 9, 2011, the bill was introduced in the Senate under S. 1831 and referred to the Senate Committee on Banking, Housing, and Urban Affairs. The full text of the House bill is available **here**.

On January 6, 2012, the SEC Advisory Committee on Small and Emerging Companies (the "Advisory Committee") made recommendations to the SEC that mirror the changes proposed by the Access to Capital for Jobs Creators Act. According to the Advisory Committee, "the investor protections afforded by the existing restrictions on general solicitation and general advertising are not necessary in private offerings of securities whereby the securities are sold solely to accredited investors." The Advisory Committee's recommendation letter is available **here**.

3. Senate Committee's Consideration of S. 2075 Cut Unjustified Tax (CUT) Loopholes Act

On February 7, 2012, the Senate referred S. 2075, the Cut Unjustified Tax (CUT) Loopholes Act, to the Senate Committee on Finance. As proposed, the CUT Loopholes Act would, among other things, require hedge funds to establish anti-money laundering programs and submit suspicious activity reports to the Secretary of the Treasury. The full text of S. 2075 is available **here**.

4. Treasury's Report of U.S. Ownership of Foreign Securities on Form SHC

On November 9, 2011, the Treasury published its notice of mandatory survey of ownership of foreign securities by U.S. residents as of December 31, 2011 on Form SHC in the Federal Register. The notice imposes reporting requirements on all (i) U.S.-resident custodians whose total fair value of all foreign securities whose safekeeping they manage on behalf of U.S. persons, aggregated over all accounts and for all U.S. branches and affiliates of their firm, was at least $100 million as of December 31, 2011 (the "as-of date") and (ii) U.S.-resident end-investors (including affiliates in the United States of foreign entities), if the total fair value of foreign securities owned or invested on behalf of others, aggregated over all accounts and for all U.S. branches and affiliates of their firm, was at least $100 million at the as-of date. Reportable securities include certain foreign equities, short-term debt securities (including selected money market instruments), and long-term debt securities. Various types of securities are specifically excluded from the reporting requirement, including derivative contracts, loans and loan participation certificates, letters of credit, non-negotiable certificates of deposit, certain bank deposits, foreign securities temporarily acquired under certain arrangements, the underlying security of any depository receipt, and all U.S. securities. Certain direct investments are also excluded.

Generally, investment advisers would be required to file Form SHC as representatives of U.S.-resident end-investors, and should file one consolidated report of the holdings and issuances for all U.S.-resident parts of their own organizations, including all U.S.-resident entities that they advise or manage. Investment advisers who create master-feeder funds with entities both outside and inside the U.S. (*e.g.*, a master-feeder fund structure which includes a U.S. feeder fund and a foreign-resident

master fund) should report on Form SHC any investments between the U.S. and foreign-resident affiliate funds that the investment adviser sets up (*e.g.*, any investment that the U.S. feeder fund has in the foreign-resident master fund).

Form SHC must be submitted to the Federal Reserve Bank no later than March 2, 2012. The information collected by the survey will be confidential and will be made available to the general public at an aggregated level. Additional information on Form SHC is available **here**.

5. Department of Labor's Final Rule Regarding Fee Disclosures for ERISA Plan Fiduciaries

On February 2, 2012, the Employee Benefits Security Administration of the Department of Labor (the "DOL") released its final rule concerning the services, compensation and other disclosures that must be furnished to plan fiduciaries under Section 408(b)(2) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). Under Section 408(b)(2), covered service providers to employee benefit plans (including SEC- and state-registered investment advisers to certain hedge funds and other private investment vehicles the assets of which are considered "plan assets" for purposes of ERISA) may receive "reasonable compensation" for "necessary" services provided under a "reasonable" arrangement. Under the final rule, an arrangement for providing services will be treated as "reasonable" for the purposes of Section 408(b)(2) only if the service provider discloses to the plan specified compensation-related and certain other information in writing "reasonably in advance" of entering into, extending, or renewing the contract or arrangement for services. Failure to meet the requirements of Section 408(b)(2) may cause the payment of compensation to a provider of services to an ERISA plan to be a prohibited transaction under ERISA, which could result in potential liabilities on the service provider as well as the plan fiduciary.

In general, the disclosures required by the rule include a description of services to be provided pursuant to the contract or arrangement, the capacity in which such services are expected to be provided, comprehensive information about the compensation to be received in connection with the services provided (including whether the compensation is direct or indirect), and the cost to the covered plan of recordkeeping services, to the extent such services will be provided to the covered plan. The rule becomes effective on July 1, 2012 (the "Effective Date"). It is critical that service providers, including managers that provide advice to private funds that hold plan assets, ensure compliance with the disclosure requirements of the DOL's final rule by the Effective Date. Additional information on the DOL's final rule is available **here**.

C. Other Updates

1. California Publishes Proposed Private Fund Registration Exemption

On December 15, 2011, the California Department of Corporations (the "CA DOC") published a proposed rule to amend Section 260.204.9 of Title 10 of the California Code of Regulations in response to the elimination of the federal "private adviser" exemption under the Advisers Act. The proposed amendment would exempt from California's registration requirements any private fund adviser that is exempted from registration with the SEC under Section 203(m) of the Advisers Act (*i.e.*, the private fund adviser exemption) and that (i) is not subject to disqualification by the SEC, (ii) files with the CA DOC a copy of each report that an exempt reporting adviser under the Advisers Act would be required to file with the SEC pursuant to Rule 204-4 under the Advisers Act, and (iii) pays the application and renewal fees required of registered advisers.

The proposed rule imposes additional requirements on private fund advisers that advise at least one private fund that relies on the exemption from registration under Section 3(c)(1) of the Investment Company Act, of 1940, as amended (the "Investment Company Act"), and is not a venture capital company (a "covered 3(c)(1) fund"). Private fund advisers who advise covered 3(c)(1) funds must (i) advise only those covered 3(c)(1) funds whose outstanding securities (other than short-term

paper) are beneficially owned entirely by persons who, at the time of purchase from the issuer, meet the SEC's definition of "accredited investor" under the Securities Act (subject to certain grandfathering provisions); (ii) disclose to each beneficial owner of a covered 3(c)(1) fund at the time of purchase all services that will be provided, all duties the private fund adviser owes to such beneficial owner, and any other material information affecting the rights and responsibilities of such beneficial owner; (iii) deliver to each beneficial owner of each covered 3(c)(1) fund, on an annual basis, audited financial statements of each covered 3(c)(1) fund; and (iv) comply with California's rules regarding performance fee restrictions.

The proposed rule extends the temporary exemption from registration for private fund advisers currently in effect through June 28, 2012.[2] The proposed rule gives an investment adviser who becomes ineligible for the exemption provided in the proposed rule 90 days to comply with registration or notice filing requirements. On February 6, 2012 the CA DOC revised the notice of proposed rulemaking and extended the comment period on the proposed exemption until March 25, 2012. Additional information on the proposed rule is available **here**.

2. Delaware Court of Chancery's Application of Traditional Fiduciary Duties to LLCs in Auriga Capital Corp. v. Gatz Properties, LLC

On January 27, 2012, the Delaware Court of Chancery ruled that, absent contractual language to the contrary, a limited liability company ("LLC") agreement does not displace the traditional duties of loyalty and care that are owed by managers of Delaware LLCs to their members.[3] The court began its analysis with Section 18-1104 of the Delaware Limited Liability Company Act (the "LLC Act"), which provides the statutory mandate for courts to apply the rules of equity, including fiduciary duties, to LLCs. The court then analyzed whether the manager of an LLC would qualify as a fiduciary of that LLC. Because "[t]he manager of an LLC has more than an arms-length, contractual relationship with the members of the LLC," the court deemed it "obvious" that under traditional principles of equity, a manager of an LLC would qualify as a fiduciary of that LLC and its members."[4] Accordingly, "because the LLC Act provides for principles of equity to apply, because LLC managers are clearly fiduciaries, and because fiduciaries owe the fiduciary duties of loyalty and care, the LLC Act starts with the default position that managers of LLCs owe enforceable fiduciary duties" to the members of the LLC.[5] Therefore, where limitations or waivers of the traditional fiduciary duties of loyalty and care are desired by the LLC managers, the LLC governing documents must expressly modify or eliminate such duties. Additional information on the court's ruling is available **here**.

3. SEC's National Examination Risk Alert on the Use of Social Media by Investment Advisers

On January 4, 2012, OCIE issued a National Examination Risk Alert on Investment Adviser Use of Social Media (the "Alert"). The Alert acknowledges the increasing use of social media by the financial services industry for various purposes and reiterates that investment advisory firms' use of social media must comply with various provisions of federal securities law, including but not limited to the antifraud provisions, compliance provisions and recordkeeping provisions. The Alert also provides a non-exhaustive list of items that firms that permit the use of social media should consider in complying with their obligations under the federal securities laws. These include, among others, creating adequate guidelines governing usage and content of social media, monitoring the firms' social media sites, dedicating sufficient compliance resources, providing adequate training related to the use of social media, and considering the information security risks posed by the use of social media. In addition, the Alert recommends that firms adopt policies and procedures concerning third-party postings, where applicable, as well as policies and procedures concerning compliance with the recordkeeping obligations of registered investment advisers, which do not differentiate among various media and thus apply to social media. According to the Alert, registered investment advisers "that communicate through social media must retain records of those communications if they contain information that satisfies an investment adviser's recordkeeping obligation under the Advisers Act."

Generally, registered investment advisers must retain records generated by social media communications in a manner that is easily accessible for a period of not less than five years. The full text of the Alert is available **here**.

4. Cayman Islands Government Passes the Mutual Funds (Amendment) Bill

On December 5, 2011, the Cayman Islands Government passed the Mutual Funds (Amendment) Bill, 2011 (the "Amendment"), which requires the registration of certain Cayman Island master funds with the Cayman Islands Monetary Authority ("CIMA"). The Amendment defines a master fund subject to the registration requirements as a "mutual fund that is incorporated or established in the [Cayman Islands] that holds investments and conducts trading activities and has one or more regulated feeder funds." A regulated feeder fund is further defined as "a regulated mutual fund that conducts more than 51% of its investing through another mutual fund." The registration requirements became effective on December 22, 2011. On March 20, 2012, the Cayman Islands Government extended the deadline for registration of master funds in existence as of December 22, 2011 by sixty days, from March 21, 2012 to May 21, 2012. Master funds can register with CIMA by submitting a completed and signed Form MF4 in addition to the master fund's current offering documents, proof of incorporation/registration, and a registration fee. Registered master funds will be subject to the obligations of registered funds under the Cayman Islands Mutual Funds Law, including the required submission to CIMA within six months of the fund's fiscal year end of (i) annual audited financial statements signed off by a CIMA-approved auditor and (ii) general, operating and financial information on the master fund on the Fund Annual Return Form.

5. FinCEN's Consideration of Anti-Money Laundering Rules for Investment Advisers

On November 15, 2011, in a talk given at the American Bankers Association/American Bar Association Money Laundering Enforcement Conference, James H. Freis, Jr., the Director of the Financial Crimes Enforcement Network ("FinCEN"), indicated that FinCEN is currently working on a regulatory proposal that would require investment advisers to establish anti-money laundering ("AML") programs and report suspicious activity under the Bank Secrecy Act of 1970, as amended (the "BSA"). FinCEN had previously proposed rules applicable to investment advisers under the BSA in 2003, which were later withdrawn on November 4, 2008. In issuing its new rules, FinCEN plans to build on changes to the industry pursuant to the Dodd-Frank Act, the SEC rules implementing the Dodd-Frank Act and other changes. Compliant AML programs typically require written policies, procedures and internal controls reasonably designed to comply with the BSA rules and regulations. The full text of the remarks is available **here**.

II. TAXATION

A. White House Budget Proposal

One of the recent tax developments since our last Report relates to the White House releasing the fiscal year 2013 budget proposal on February 13, 2012. Among other items, President Obama proposes eliminating the alternative minimum tax (which was adopted in 1969 in order to target wealthy taxpayers who paid minimal taxes and has been criticized due to subsequent lack of adjustment for inflation) and instituting in its place a thirty percent (30%) tax on incomes in excess of $1,000,000. For taxpayers earning more than $200,000 per year, the budget proposal would additionally tax dividends at ordinary income rates.

Consistent with the Obama administration's proposal in the American Jobs Act of 2011, the budget proposal also taxes as ordinary income a partner's share of income on an "investment services partnership interest" in an investment partnership, regardless of the character of the income at the partnership level. Accordingly, such income would not be eligible for the reduced rates that currently apply to long-term capital gains of individuals. Such "carried interest legislation" has been met with

strong resistance in the past but has garnered increased support in part due to Mitt Romney's campaign and ensuing discussions of the tax treatment of carried interest in the alternative investment industry.

While it is highly unlikely that the proposed budget will gain bipartisan support and pass unchanged, the proposal provides some insight into the Obama administration's platform in the current election year, including, as President Obama stated at a speech in December 2011, a desire to restore economic fairness.[6] We will continue to monitor the progress of the budget proposal.

B. Carried Interest Legislation

In addition to the carried interest provision included as part of President Obama's budget proposal, discussed above, House Ways and Means Committee ranking member Sander Levin (D-Mich.) proposed legislation on February 14, 2012 that would tax carried interest earned in managing investment funds at ordinary income tax rates. H.R. 4016, the Carried Interest Fairness Act, would additionally subject such carried interest to employment taxes. As noted above, this type of carried interest legislation is not a new development (in fact, Representative Levin proposed versions of carried interest legislation as early as 2007) and has not previously gathered enough support to pass. We will continue to monitor the progress of the Carried Interest Fairness Act.

C. Capital Gains Rates Set to Rise

Capital gains tax rates are scheduled to rise in 2013. Absent Congressional action, the fifteen percent (15%) rate will expire along with other 2001 and 2003 tax cuts after December 31, 2012, and the capital gains top tax rate will return to twenty percent (20%). Without knowing which party will control the presidency or Congress, it is difficult to anticipate whether taxpayers should dispose of capital assets during the current taxable year in order to take advantage of lower capital gains tax rates. Private funds that are able to take advantage of long-term capital gains rates may wish to examine their portfolios in late 2012 in light of legislative proposals at such time. We will continue to monitor legislation regarding capital gains and other applicable tax rates.

D. Recent Foreign Account Tax Compliance Act Developments

The Foreign Account Tax Compliance Act ("FATCA"), which was enacted in March 2010 in the Hiring Incentives to Restore Employment (HIRE) Act, requires a foreign financial institution ("FFI") to enter into an agreement with the Internal Revenue Service (the "IRS") and report U.S. accounts to the IRS or pay a thirty percent (30%) withholding tax on any "withholdable payment" made to the institution or their affiliates.[7] FATCA also requires certain non-financial foreign entities to provide withholding agents information on their substantial U.S. owners.

Since FATCA's enactment, the IRS has released preliminary guidance regarding implementing the reporting and withholding requirements under FATCA, including Notice 2011-53, discussed in our last Report. Notice 2011-53 modified guidance provided in Notice 2010-60 and Notice 2011-34, also discussed in previous Reports.

On February 8, 2012, the IRS released nearly 400 pages of proposed regulations providing additional guidance on the implementation of the reporting and withholding requirements under FATCA. The proposed regulations provide much needed clarity on many FATCA issues, but significant issues remain to be resolved. The more notable aspects of the proposed regulations are discussed in our recent Client Alert, which may be found **here**.

A fund that is subject to FATCA may incur FATCA's withholding tax if any one of its investors fails to provide such fund with certain information required by FATCA to be reported to the IRS. In light of this, funds that are subject to FATCA should consider modifying their fund documents to provide

protection to the fund against any investors whose failure to provide such required information causes the fund to be subject to the FATCA withholding tax. This may include, for example, language in a subscription agreement allowing the fund to cause the compulsory withdrawal of any non-compliant investor's interests and/or requiring the non-compliant investor to indemnify, defend and hold harmless the fund against or for any cost, claim, liability, damage, loss, or expense arising out of or connected with the investor's failure to provide the required information to the fund.

On March 2, 2012, speaking at the Federal Bar Association Section on Taxation 36th Annual Tax Law Conference, IRS Chief Counsel William Wilkins stated that the IRS intends to provide additional guidance "well before the end of 2012," including a draft model FFI agreement and final regulations. We will continue to monitor the guidance provided by the IRS under FATCA.

E. Recent FBAR Developments

As discussed in previous issues of our Report, U.S. persons who have an interest in or signatory authority over a foreign account with a value over $10,000 are required to file a Foreign Bank Account Report ("FBAR"). The IRS has been actively calling for FBAR compliance and has instituted significant civil and criminal penalties for those who fail to file FBARs.

Since our last Report, the IRS provided new guidance for those who are required to file FBARs. On December 7, 2011, the IRS issued a fact sheet, FS-2011-13 (the "Fact Sheet"). The Fact Sheet, discussed in detail below, addresses the rules applicable to U.S. citizens who reside outside the United States and who have failed to timely file U.S. tax returns or FBARs.

FinCEN also released Notice 2012-1 on February 14, 2012. Notice 2012-1 extends the FBAR reporting deadlines for certain foreign financial accounts to June 30, 2013. The extended deadline applies to individuals whose filing due date for reporting signature authority was previously extended by Notices 2011-1 (as revised) or 2011-2 (such notices covered some taxpayers with signature authority over, but no financial interest in, foreign financial accounts). For all other individuals with an FBAR filing obligation, the filing due date remains unchanged.

In addition, on February 24, 2012, FinCEN announced a general exemption until July 1, 2013 from mandatory electronic FBAR filing. FinCEN previously announced that it would require FBARs to be filed electronically as of June 30, 2012. The temporary exemption does not relieve any person of the obligation to file an FBAR but provides one additional year before electronic filing is required. Certain institutions that demonstrate a substantial hardship may also be eligible for a limited duration hardship exception from the requirement to file FBARs electronically.

1. U.S. Federal Income Tax Filing Requirement and Possible Penalties Reaffirmed

The Fact Sheet reaffirms that U.S. citizens and resident aliens (referred to in the remainder of this section as "U.S. taxpayers") must file a federal income tax return for any tax year in which their gross income is equal to or greater than the applicable exemption amount and standard deduction. U.S. taxpayers who fail to file U.S. tax returns or who fail to pay the amount of tax owed may be subject to penalties imposed under the Internal Revenue Code of 1986, as amended (the "Code"). Such penalties may be abated if noncompliance is due to reasonable cause.

2. FBAR Filing Requirement Reinforced

The Fact Sheet reinforces the rule that U.S. taxpayers may be required to report an interest in certain foreign financial accounts on an FBAR. The IRS further notes that U.S. taxpayers who are delinquent in their FBAR filings should file the delinquent FBARs and attach a statement explaining why they are filed late (other than FBARs that were due more than six years ago because the statute of limitations

for assessing FBAR penalties is six years from the FBAR due date). In the absence of reasonable cause, failure to file an FBAR will result in significant penalties.

3. No Penalty for Late FBAR Filings Due to Reasonable Cause

The Fact Sheet makes clear that if the failure to file an FBAR is due to reasonable cause, the IRS will not assert a penalty for the failure. The Fact Sheet lists factors that may weigh in favor of a determination that an FBAR violation was due to reasonable cause, including:

- reliance upon the advice of a professional tax advisor who was informed of the existence of the foreign financial account;
- establishment of the unreported account for a legitimate purpose;
- lack of indications of efforts taken to intentionally conceal the reporting of income or assets; and
- lack of tax deficiency (or a *de minimis* tax deficiency) related to the unreported foreign account.

The Fact Sheet additionally lists factors that may weigh against a determination that an FBAR violation was due to reasonable cause, including:

- whether the taxpayer's background and education indicate that he should have known of the FBAR reporting requirements;
- whether there was a tax deficiency related to the unreported foreign account; and
- whether the taxpayer failed to disclose the existence of the account to the person preparing his tax return.

4. Takeaway

The Fact Sheet does not provide a blanket amnesty for failure to file U.S. federal income tax returns or FBARs or for failure to pay U.S. federal income taxes, but it provides helpful parameters within which a U.S. taxpayer may show reasonable cause to avoid penalties for noncompliance and come into good standing with U.S. tax laws.

F. New Reporting Requirement for Individuals with Foreign Financial Assets

Code Section 6038D was enacted in 2010 as part of the HIRE Act to compel individuals who are U.S. taxpayers with offshore financial accounts to disclose interests in certain "specified foreign financial assets" with an aggregate value exceeding $50,000 for tax years beginning after March 18, 2010. Higher thresholds apply to U.S. taxpayers who file a joint return or who reside abroad (see below). The new disclosure obligation generally became effective for calendar year 2011. Disclosure is accomplished by submitting a statement with a taxpayer's annual federal income tax return containing certain identifying information.

As an anti-abuse measure, the IRS is authorized to provide that Code Section 6038D applies in the same manner to any domestic entity formed or availed of for the purpose of holding such financial assets as it applies to individuals.

On December 19, 2011, the IRS released temporary and proposed regulations under Code Section 6038D that provide much needed guidance on the application of Code Section 6038D. Taxpayers who have FBAR filing obligations (discussed above) will see a lot of familiarities between the FBAR requirement and the Code Section 6038D filing requirement. In fact, the Code Section 6038D filing

requirement is often referred to as a "tax FBAR." However, the Code Section 6038D requirement is broader than the FBAR requirement.

1. Specified Foreign Financial Assets

For purposes of Code Section 6038D reporting, a "specified foreign financial asset" is defined as any financial account maintained by a foreign financial institution and, to the extent not held in an account at a financial institution: (i) any stock or security issued by any person other than a U.S. person; (ii) any financial instrument or contract held for investment that has an issuer or counterparty that is not a U.S. person; and (iii) any interest in a foreign entity.

Certain assets are excepted from the definition of specified foreign financial asset, including: (i) a financial account that is maintained by a U.S. taxpayer, such as a domestic financial institution; and (ii) a financial account that is maintained by a dealer or trader in securities or commodities if all of the holdings in the account are subject to the mark-to-market accounting rules for dealers in securities or an election under Code Section 475(e) or (f) to use mark-to-market accounting is made for all of the holdings in the account.

2. Reportable Information

If an individual holds specified foreign financial assets in an aggregate value exceeding $50,000, the individual must report on Form 8938 *Statement of Specified Foreign Financial Assets* ("Form 8938") the following information for each asset:

- the name and address of the financial institution in which the account is maintained;
- the account number;
- for any stock or security, the name and address of the non-U.S. issuer and information necessary to identify the class or issue of which the stock or security is a part;
- for any other instrument, contract or interest, the names and addresses of all issuers and counterparties and information necessary to identify the instrument, contract or interest; and
- the maximum value of each specified foreign financial asset during the taxable year.

3. Reporting Thresholds

Reporting thresholds in filing Form 8938 are as follows:

- Unmarried taxpayers living in the United States: total value of the taxpayer's foreign financial assets is more than $50,000 on the last day of the tax year or more than $75,000 at any time during the tax year.
- Married taxpayers filing a joint income tax return and living in the United States: total value of the taxpayers' foreign financial assets is more than $100,000 on the last day of the tax year or more than $150,000 at any time during the tax year.
- Married taxpayers filing separate income tax returns and living in the United States: total value of the taxpayer's foreign financial assets is more than $50,000 on the last day of the tax year or more than $75,000 at any time during the tax year.
- Unmarried taxpayers and married taxpayers filing separate income tax returns, in each case living outside the United States: total value of the taxpayer's foreign financial assets is more than $200,000 on the last day of the tax year or more than $300,000 at any time during the tax year.

- Married taxpayers filing a joint income tax return and living outside the United States: total value of the taxpayers' foreign financial assets is more than $400,000 on the last day of the tax year or more than $600,000 at any time during the tax year.

4. Application to Domestic Entities

Although Code Section 6038D is generally applicable to specified individuals, it may apply to specified domestic entities. The IRS addressed the latter in proposed regulations released December 19, 2011. Such specified domestic entities include corporations, partnerships and trusts formed or availed of for purposes of holding specified foreign financial assets. If adopted, the proposed regulations would apply the Code Section 6038D reporting requirements to such domestic entities as well as specified individuals. Until then, no domestic entity is required to file Form 8938. The full text of the proposed regulation is available **here**.

5. Exception to Reporting Requirement

Among other exceptions, a taxpayer who does not have to file a U.S. federal income tax return for the tax year does not have to file Form 8938, even if the value of the taxpayer's assets exceeds the appropriate reporting threshold described above.

6. Penalties

Failure to file a correct Form 8938 in a timely manner or reporting an understatement of tax or omission of income relating to a specified foreign financial asset may subject a taxpayer to penalties. The initial penalty for a failure to file a timely and correct Form 8938 is $10,000. The penalty for a continuing failure to file a timely and correct form after the IRS mails notice of the failure to file is $10,000 for each thirty day period (or portion thereof) during which the taxpayer continues to fail to file Form 8938 after a ninety period has expired (up to a maximum of $50,000). However, no penalty will be imposed if a taxpayer is able to show facts that support a reasonable cause claim for the failure. Note that the fact that a foreign jurisdiction would impose a civil or criminal penalty on a taxpayer for disclosure of the required information to the IRS is not considered reasonable cause.

The penalty for reporting an understatement of tax or omitting applicable income is equal to forty percent (40%) of the underpayment. The penalty for an underpayment due to fraud is equal to seventy-five percent (75%) of the underpayment due to fraud.

In addition to the penalties discussed above, a failure to file Form 8938, failure to report an applicable asset, or reporting an underpayment of tax may subject a taxpayer to criminal penalties.

7. Application to Private Fund Investors

The Code Section 6038D rules require U.S. taxpayers with investments in foreign entities, such as foreign hedge funds, to report the existence of such investments. Accordingly, U.S. taxpayers investing in offshore funds may have a reporting obligation under Code Section 6038D. In contrast, such accounts are generally exempted from FBAR reporting pursuant to regulations issued by FinCEN in February 2010.

8. Form 8938 and Instruments

Form 8938 and its instructions were released on December 19, 2011. The form may be found **here** and the instructions may be found **here**.

G. IRS Releases Guidance on Providing Schedules K-1 Electronically to Recipients

On February 14, 2012, the IRS released Rev. Proc. 2012-17, which provides the requirements for furnishing substitute Schedule K-1 *Partner's Share of Income, Deductions, Credits, etc.* in electronic format. A partnership that follows the procedures outlined in the revenue procedure will satisfy its obligation to provide Schedules K-1 to its partners and nominees. The guidance generally follows prior IRS guidance regarding the same.

Rev. Proc. 2012-17 states that, subject to certain conditions, a Schedule K-1 may be furnished electronically in lieu of a paper format, subject to a partner's consent before provision of the electronic version. The consent must be made electronically in any manner that reasonably demonstrates that the recipient can access the Schedule K-1 in the electronic format in which it will be furnished. In the alternative, the consent may be made on paper and confirmed by the recipient electronically.

Any material change in hardware or software must be communicated to Schedule K-1 recipients prior to the change. Recipients must then provide new consents to receive the Schedules K-1 in the revised electronic format.

A recipient is entitled to withdraw its consent. Accordingly, the consent requirement will not be satisfied if the recipient withdraws its consent and the withdrawal takes effect before the Schedule K-1 is furnished.

For more information regarding the provision of substitute Schedules K-1 in electronic format, please see Rev. Proc. 2012-17, found **here**.

H. Proposed New York City Audit Position

New York City imposes an unincorporated business tax ("UBT") on net income allocated to the city of any unincorporated entity (including partnerships and limited liability companies) doing business in the city. Currently, the UBT rate is four percent (4%). A statutory exemption is available from UBT for entities that are primarily engaged in business in New York City by reason of certain investment activities. As a result, private funds doing business in New York City often form both a management entity to perform management functions and receive management fees, which are subject to UBT, and a general partner entity that does not undertake management activities to receive a carried interest, which is not subject to UBT. The management entity is generally able to reduce its UBT burden by deducting expenses associated with its management services.

It has come to our attention that the New York City Department of Finance has proposed a new audit position whereby it will disallow a portion of the expense deductions claimed by private fund management entities. The proposed audit position requires reallocation of a portion of such expense deductions to the associated general partner entity under the theory that at least a portion of the deductions claimed by the management entity arise from the general partner entity's carried interest. It is unclear how expenses would be reallocated between the management entity and the general partner entity. However, as a result, the UBT tax burden on the management entity will be increased, whereas the general partner entity will not obtain any tax benefit from the expense deductions as its carried interest is not subject to UBT.

The proposed audit position has not been published, and it is unclear to what extent the New York City Department of Finance will pursue the position and whether it will apply retroactively. We will continue to monitor the progress of the proposed audit position.

III. CIVIL LITIGATION

Hedge funds continue to be involved in litigation, both as defendants and plaintiffs, over a wide variety of issues. Recent rulings dealt with such important issues as the availability of arbitration for claims involving hedge funds and the significance of a hedge fund manager's signature on investment documents. These rulings include the following:

- The Second Circuit held that a hedge fund was not a "customer" of a FINRA member whose related bank had entered a credit default swap agreement with the hedge fund; thus, the hedge fund could not pursue arbitration under FINRA rules.

- A federal judge in the Middle District of Florida compelled arbitration of clawback actions based on arbitration provisions in fund documents signed by fund managers, even though they were not signed by directors.

- The New York Appellate Division affirmed the lower court's denial of a hedge fund manager's motion for summary judgment, holding that the manager could potentially be personally liable under investment agreements because he had signed on his own behalf.

- The Delaware Chancery Court sanctioned a class representative plaintiff, a fund manager, for trading in the defendants' shares based on confidential information obtained during the suit.

A. Update on Previously Reported Cases

Complaints against Banks Accused of Colluding to Manipulate LIBOR Consolidated in Southern District of New York

In the Fall 2011 issue of our Report, we noted that European asset manager FTC Capital GMBH ("FTC Capital") and two of its futures funds had filed a putative class action in the Southern District of New York, alleging that during the 2006-2009 period, twelve banks conspired to artificially depress the London interbank offered rate ("LIBOR"). FTC Capital alleged that the defendant banks colluded to suppress LIBOR in order to make the banks appear more financially healthy than they actually were.

Since the complaint was filed, the litigation has become more complex, leading to an effort to streamline it through consolidation. The Judicial Panel on Multi-District Litigation transferred twenty-two other cases involving LIBOR to the Southern District of New York,[8] and on November 29, 2011, the court consolidated the actions and appointed interim class counsel for two putative classes of plaintiffs, one group that engaged in over-the-counter transactions and another group that purchased financial instruments on an exchange.

B. New Developments in Securities Litigation

1. Hedge Fund Enjoined from Arbitration against FINRA Member

In May 2007, VCG Special Opportunities Master Fund Ltd. ("VCG"), a hedge fund, entered a credit default swap agreement with Wachovia Bank, N.A. ("Wachovia Bank"). Directors at Wachovia Capital Markets, LLC ("Wachovia Capital"), an affiliate of Wachovia Bank, had participated in the negotiations, but Wachovia Capital was not a party to the agreement. The agreement specifically included a non-reliance clause in which each party disclaimed any reliance on the other party or its affiliates.

In November 2007, VCG sued Wachovia Bank over disagreements regarding the collateral requirements under the agreement. The court eventually granted summary judgment in favor of Wachovia Bank in that proceeding. In the meantime, in May 2008, VCG initiated arbitration against Wachovia Capital, based on Wachovia Capital's status as a member of the Financial Industry Regulatory Authority ("FINRA").

Wachovia Bank and Wachovia Capital then sought to enjoin the arbitration on the ground that VCG did not have an arbitration agreement with Wachovia Capital and was not a customer of Wachovia Capital. Under the FINRA Code of Arbitration Procedures for Customer Disputes (the "FINRA Code"), a member must arbitrate disputes in connection with its business activities when requested to do so by its "customer." The parties brought cross-motions for summary judgment on the Wachovia parties' claim for injunctive relief. The district court granted VCG's summary judgment motion, dismissing the case and directing the parties to arbitration.

On October 28, 2011, the Second Circuit reversed the district court's ruling.[9] The Second Circuit found that VCG had no relationship with Wachovia Capital and thus, VCG could not be a customer within the meaning of the FINRA Code. There was no brokerage agreement between VCG and Wachovia Capital. Furthermore, because the parties explicitly disclaimed reliance on the others' affiliates, there was "no need to grapple with the precise boundaries of the FINRA meaning of 'customer.'" Thus, the Court reversed the district court's grant of summary judgment and remanded for entry of an injunction against VCG.

2. Funds Sent to Arbitration Based on Managers' Signatures on Fund Documents

On September 29, 2011, a federal judge in the Middle District of Florida compelled arbitration of twenty-three of the "clawback" actions brought by the receiver of fraudulent hedge funds to recover false profits from the funds' investors.[10]

The clawback actions emanated from an SEC enforcement action dealing with a Ponzi scheme perpetrated by fund manager Arthur Nadel. The Middle District of Florida appointed a receiver for the funds, charged in part with rounding up assets. The receiver sued more than 150 investors, demanding a return of false profits. Twenty-three of the investors moved for arbitration of the suits. The investors argued that arbitration clauses in the funds' documents, although signed by the funds' managers and not by directors, were enforceable.

On June 8, 2011, Magistrate Judge Mark A. Pizzo recommended that the Court order arbitration. Judge Kovachevich adopted the recommendation. In so doing, the Court held that an arbitration provision in a fund document signed by a manager but not by a director is enforceable, absent extraordinary circumstances. The Order noted that attacks on the validity of an arbitration clause based on the manager's lack of authority to bind the fund could be decided in arbitration, since they did not go to the existence of the contract as a whole. Because the receiver did not argue that the managers' signatures were forged or otherwise fraudulent, the managers' signatures in the fund documents were sufficient to compel the funds to arbitrate.

This ruling is indicative of the expansive interpretation given to arbitration provisions, and points up the need for funds to ensure that arbitration clauses are analyzed and vetted carefully prior to inclusion in fund documents or agreements.

3. Hedge Fund Manager May Be Personally Liable Under Investment Agreement

In another case involving the legal effect of a hedge fund manager's signature, on January 12, 2012, New York's Appellate Division affirmed a lower court's ruling denying the hedge fund manager's motion for summary judgment.[11]

Defendant Peter Sasaki was the manager of two hedge funds. Defendants Logos Capital Management, LLC ("Logos"), and Quix Partners, LLC ("Quix"), which Sasaki owned, were the investment advisor and general partner of the funds. Plaintiffs had entered into investment agreements with Sasaki to build the business of Logos and Quix. When plaintiffs sought to sell their interests, Sasaki intervened, and plaintiffs sued.

Defendants moved for summary judgment. The trial court dismissed plaintiffs' claims for conversion, unjust enrichment, and tortious interference with prospective business relations, but denied summary judgment as to the other claims.

Sasaki argued that he could not be personally liable under the agreements with plaintiffs because he signed solely as a representative of Logos and Quix. Because the agreements were ambiguous in this regard, the trial court held that it was an issue for trial.

The Appellate Division affirmed, pointing to several facts. First, "[t]he prefatory clauses do not state that Sasaki intended to execute the agreements on behalf of or as an agent for" Logos and Quix. Second, "Sasaki was individually named throughout the agreements." Third, Sasaki was granted the right of first refusal if plaintiffs sought to sell their shares. Thus, the Appellate Division affirmed the denial of summary judgment.

This case shows that hedge funds drafting agreements should clearly identify the parties to the agreement and include whether the principal is signing in his or her capacity as an officer or manager of the entity or in any personal capacity.

4. Plaintiff Fund Manager Sanctioned for Trading on Confidential Information

A recent decision demonstrates that even after litigation begins, a hedge fund manager who acts as a plaintiff and class representative owes a fiduciary duty to refrain from trading on non-public information learned as a result of the litigation.

In October 2010, Michael Steinhardt, Herbert Chen, two hedge funds managed by Steinhardt, and one other individual brought a class action to enjoin the acquisition of defendant Occam Networks, Inc. ("Occam") by Calix, Inc. ("Calix").

The Court entered a confidentiality order limiting use of confidential information to the pending litigation and providing that "Confidential Discovery Material shall not be used for any other purpose." The order also dictated that plaintiffs "who receive Confidential Discovery Material shall not purchase, sell, or otherwise trade in the securities of any company, including but not limited to Occam and Calix, on the basis of confidential information contained in the Confidential Discovery Material to the extent such information is still confidential at the time of such purchase, sale or trade."

On December 28, 2010, Steinhardt began to short sell Calix common stock, continuing to do so through the closing of the merger. On January 25, 2011, Chen sold Occam shares, which he testified was due to an error in selecting which stock to sell.

When the defendants learned of the sales, they moved for sanctions. In its order, the Court noted that, under Delaware law, a representative plaintiff in a class action "voluntarily assumes the role of fiduciary for the class" and is prohibited from trading "on the basis of non-public information obtained through discovery."

The Delaware Chancery Court found that Steinhardt, but not Chen, had violated his fiduciary duty as a class representative, dismissed him and his funds from the suit, and imposed sanctions.[12] The Court directed Steinhardt to self-report his trading to the SEC and to disclose his improper trading in any future application to serve as lead plaintiff in a class action. Steinhardt and his funds were also required to disgorge profits made from the trading. Profits were calculated from the time of the commencement of the suit to the date of the hearing on the injunction, when "[i]t would have been reasonably clear to anyone buying or selling Occam or Calix shares that the Merger was highly likely to close once the supplemental disclosures went out." Thus, Steinhardt and his funds were required to disgorge $534,071.45.

IV. REGULATORY ENFORCEMENT

2011 was a milestone year for the SEC. The SEC brought a record 735 enforcement actions, and obtained orders requiring disgorgement of $1.878 billion in profits and the payment of $928 million in civil penalties.[13] In addition, the SEC opened 933 investigations for which 578 formal orders issued.[14] As in previous years, many of these enforcement actions and investigations related to hedge fund advisors and managers with traditional areas of scrutiny such as insider trading, fraudulent misrepresentations, and Ponzi schemes receiving the lion's share of the SEC's attention.

As we discussed in the last update, much of the evidence underlying these actions was developed through the use of investigative techniques more commonly associated with organized crime, such as wiretaps, search warrants, and undercover sting operations. Now, the SEC has added yet another tool to its investigation toolbox. Under the SEC's "Aberrational Performance Initiative,"[15] (the "Initiative") the SEC has developed a computer monitoring program that tracks fund performance results and compares those results to overall market performance and volatility. Any "aberrational performances" (such as returns that greatly exceed those of other funds) are then investigated for possible enforcement actions. The SEC has filed several actions stemming from the Initiative, including enforcement actions against three separate advisory firms and six individuals for the alleged misuse of fund assets, fraudulent valuations, and misrepresenting fund returns.[16]

Commenting on the success of the Initiative and on the resulting enforcement actions, Robert Kaplan and Bruce Karpati, Co-Chiefs of the SEC Enforcement Division's Asset Management Unit, explained, "[t]he extraordinary returns reported by these advisors and portfolio managers were, in most cases, too good to be true. In other cases, outlier returns were a telltale sign that something else was amiss."[17] Encouraged by the results thus far, the SEC announced that they would continue "applying analytics across the investment adviser space – beyond performance and beyond hedge funds."[18] The Wall Street Journal reports that, based on the results of the Initiative, the SEC now has a "most-wanted list" of approximately 100 hedge fund advisors suspected of being involved in some form of fraudulent activity. This almost certainly guarantees that the SEC will continue to focus its enforcement efforts on hedge fund advisors and managers in 2012 and beyond.[19]

A. Insider Trading

The recent, well-publicized news that the FBI has "enough informants lined up to keep its investigations of suspected illegal insider trading at hedge funds going for at least five more years" underscores the focus the SEC and the Department of Justice have on eradicating illegal insider trading.[20] In that regard, there has been a steady stream of insider trading enforcement actions against hedge funds over the last six months. Two of the more recent decisions are highlighted below.

1. SEC v. Adondakis

In *SEC v. Adondakis*,[21] the SEC filed a civil injunctive action in the U.S. District Court for the Southern District of New York against hedge fund advisors Diamondback Capital ("Diamondback") and Level Global, and seven hedge fund analysts and traders on allegations of insider trading concerning Dell, Inc. ("Dell") and Nvidia Corporation ("Nvidia").

According to the complaint, a "Dell insider" passed material nonpublic information about Dell, including quarterly earnings data, to investment analyst Sandeep "Sandy" Goyal.[22] Goyal then allegedly passed that information to Diamondback analyst Jess Tortora in return for "soft dollar payments" of at least $175,000. Tortora, in turn, purportedly tipped Todd Newman, Jon Horvath and Danny Kuo "leading to insider trades on behalf of Diamondback and Level Global hedge funds."[23] According to the SEC, Newman also tipped Spyridon "Sam" Adondakis, an analyst at Level Global, who then allegedly passed

the Dell inside information along to Anthony Chiasson so that Level Global could trade on that information.

Regarding Nvidia, the complaint alleges that in 2009 Kuo obtained material nonpublic information concerning Nvidia's financial performance. Kuo allegedly used this information for the benefit of his employer and passed the information along to other individuals, including Adondakis and Tortora. Adondakis and Tortora then passed the information on to Chiasson and Newman, respectively, who used the information to trade in Nvidia securities.[24] According to the SEC, "the illicit gains in the Dell insider trades exceeded $62.3 million, and the illicit gains in the Nvidia insider trades exceeded $15.7 million."[25]

Each defendant was charged with violations of Section 17(a) of the Securities Act, and Section 10(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") and Rule 10b-5 thereunder.[26] Additionally, Goyal, Tortora, Newman, Adondakis, Chiasson, Horvath and Kuo were charged with aiding and abetting others' violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.[27] The SEC is seeking "a final judgment ordering the defendants to disgorge their ill-gotten gains plus prejudgment interest, ordering them to pay financial penalties, and permanently enjoining them from future violations of these provisions of the federal securities laws."[28]

2. SEC v. Whitman

In *SEC v. Whitman*,[29] the SEC filed a civil injunctive action in the U.S. District Court for the Southern District of New York against hedge fund manager Douglas F. Whitman and his hedge fund advisor firm Whitman Capital relating to the insider trading ring connected to Raj Rajaratnam and Galleon Management LP ("Galleon"). The complaint alleged that Whitman and Whitman Capital traded on material nonpublic information in the securities of Polycom, Inc. ("Polycom") and Google, Inc. ("Google"). Whitman purportedly obtained this material nonpublic information from an individual investor named Roomy Khan.[30] Khan obtained the information from a senior executive at Polycom and an employee of an investor relations firm that provided consulting services to Google.[31] Whitman Capital hedge funds allegedly earned $980,000 in illegal profits from the insider trading.

The SEC charged Whitman and Whitman Capital with violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 17(a) of the Securities Act.[32] The complaint seeks a final judgment permanently enjoining the defendants from future violations of the above provisions of the federal securities laws, ordering them to disgorge their ill-gotten gains plus prejudgment interest, and ordering them to pay financial penalties. As of the date of its complaint against Whitman, the SEC had charged 30 defendants in its Galleon-related enforcement actions.[33]

B. Expert Network Firms

In recent months, the SEC has focused its attention on so-called "expert network" firms, which connect industry experts with investment managers for professional investment research advice. Often the experts, commonly referred to as consultants, are employees who provide information and data regarding their employer or their employer's customers. While expert network firms can be a legitimate research tool for investors, the SEC believes that some investors and consultants have been using these arrangements to engage in insider trading.

In previous issues of our report, we discussed the case of *SEC v. Longoria*, in which the SEC alleged that several consultants engaged in illegal insider trading by selling material, nonpublic information to hedge fund portfolio managers. Below, we highlight recent developments in the case.

In *SEC v. Longoria*,[34] the SEC filed a complaint on February 3, 2011, charging two employees of the so-called "expert network" firm, Primary Global Research LLC ("PGR"), and four consultants with insider trading for illegally tipping hedge funds and other investors.[35] On February 8, 2011, the SEC

filed an Amended Complaint, charging a New York-based hedge fund advisor and four hedge fund portfolio managers and analysts for illegally trading on confidential information obtained from technology company employees moonlighting as expert network consultants.[36] In particular, the SEC alleged that, from approximately 2008 through 2010, Jason Pflaum, a former analyst at Barai Capital Management ("Barai Capital"), Samir Barai, the founder of Barai Capital, Noah Freeman, a former employee at a hedge fund advisor, and Donald Longueuil, a former portfolio manager and managing director at a hedge fund advisor, all received material nonpublic information supplied by Mark Anthony Longoria, Bob Nguyen and Walter Shimoon, who worked as paid consultants for PGR. The SEC also alleged that Longoria, Nguyen and Shimoon provided information regarding several publicly traded securities and caused Barai Capital to execute securities trades based on that information.[37] According to the SEC, Longoria, Nguyen and Shimoon met with industry insiders to obtain inside information and then conveyed this information to PGR clients, either directly via emails and telephone conversations, or indirectly by referring the clients to PGR consultants possessing the inside information that they were seeking.[38]

According to the SEC, the scheme netted more than $30 million from trades based on material, nonpublic information concerning Advanced Micro Devices, Seagate Technology, Western Digital, Fairchild Semiconductor, and Marvell Technology Group.[39]

On November 9, 2011, the Honorable Jed S. Rakoff, U.S. District Judge for the Southern District of New York, entered a judgment on consent as to Longoria. This judgment followed another judgment on consent as to Longueuil, which was entered on September 12, 2011.[40] Moreover, still in the same case, Judge Rakoff entered judgments on consent as to Freeman on December 23, 2011; as to Nguyen, Barai and Barai Capital on January 23, 2012; as to Pflaum on February 21, 2012; and as to Shimoon on February 24, 2012.[41]

The Final Judgments entered are as follows:

Defendant	**Penalty**
Mark Anthony Longoria	1. permanently enjoined from violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 17(a) of the Securities Act; 2. ordered liable for disgorgement of ill-gotten gains of $178,850, together with prejudgment interest of $18,328.94, for a total of $197,178.94; and 3. permanently barred from acting as an officer or director of a public company.
Donald Longueuil	1. permanently enjoined from violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; 2. ordered to pay disgorgement in the amount of $250,000, plus prejudgment interest in the amount of $102,832.60, for a total of $352,832.60; and 3. barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization, pursuant to a September 27, 2011 order on consent in a related administrative proceeding.[42]

Defendant	Penalty
Noah Freeman	1. permanently enjoined from violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; 2. ordered liable for disgorgement of ill-gotten gains of $833,480, together with prejudgment interest of $180,548, for a total of $1,014,028; and 3. barred from association with any broker, dealer, investment adviser, municipal securities dealer or transfer agent pursuant to a January 20, 2012 order on consent in a related administrative proceeding.[43]
Bob Nguyen	1. permanently enjoined from violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; 2. ordered liable for disgorgement of ill-gotten gains of $190,890.04, together with prejudgment interest of $11,449.16, for a total of $202,339.20; and 3. barred from association with any broker, dealer, investment adviser, municipal securities dealer or transfer agent, and from participating in any offering of a penny stock in a separate administrative proceeding.[44]
Samir Barai	1. permanently enjoined from violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; 2. ordered liable for disgorgement of ill-gotten gains of $3,000,000, together with prejudgment interest of $434,225.47, for a total of $3,434,225.47; and 3. barred from association with any broker, dealer, investment adviser, municipal securities dealer or transfer agent by consent in a separate administrative proceeding.[45]
Barai Capital	1. permanently enjoined from violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; and 2. ordered liable, jointly with Barai, for disgorgement of ill-gotten gains of $3,000,000, together with prejudgment interest of $434,225.47, for a total of $3,434,225.47.[46]

Defendant	Penalty
Jason Pflaum[47]	1. permanently enjoined from violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; 2. ordered to pay disgorgement in the amount of $101,943.00 plus prejudgment interest thereon in the amount of $11,872.38, for a total of $113,815.38; and 3. barred from association with any investment adviser, broker, dealer, municipal securities dealer, or transfer agent by consent pursuant to the entry of an order by the SEC instituting administrative proceedings pursuant to Section 203(f) of the Advisers Act.[48]
Walter Shimoon[49]	1. permanently enjoined from violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; 2. ordered to pay disgorgement in the amount of $44,175.00, plus prejudgment interest thereon in the amount of $6,099.39, for a total of $50,274.39; and 3. permanently barred from acting as an officer or director of a public company.

The SEC did not seek civil penalties against Longoria, Longueuil, Freeman, Nguyen, Barai, Pflaum, and Shimoon[50] because they cooperated with the SEC.

C. Valuation of Illiquid Assets

The SEC has continued to look closely at how hedge fund advisors value illiquid assets. As a result of the Initiative, the SEC has filed several complaints against hedge fund advisors and their managers for providing improper valuations of illiquid assets to investors.

1. SEC v. Balboa

On, December 1, 2011, the SEC charged two individuals for engaging in a fraudulent scheme to overvalue the reported returns and net asset value of the Millennium Global Emerging Credit Fund (the "Fund").[51] The SEC alleged that Michael Balboa, the Fund advisor's former portfolio manager, schemed with two European-based brokers, including Gilles De Charsonville of BCP Securities LLC, to inflate the Fund's reported monthly returns and net asset value by manipulating its supposedly independent valuation process.[52]

According to the SEC, from at least January to October 2008, Balboa surreptitiously provided De Charsonville and another broker with fictional prices for two of the Fund's illiquid securities holdings for them to pass on to the Fund's outside valuation agent and its auditor.[53] Specifically, Balboa had De Charsonville and the other broker portray the valuations for two of the Fund's illiquid securities holdings as ostensibly independent month-end marks that were provided by third-party sources when, according to the SEC, those marks were fabricated by Balboa and others.[54] According to the complaint, the scheme caused the Fund to drastically overvalue these securities holdings by as much as $163 million in August 2008, which in turn allowed the Fund to report inflated and falsely-positive monthly returns.[55]

By overstating the Fund's returns and overall net asset value, Balboa was alleged to have attracted at least $410 million in new investments, deterred about $230 million in eligible redemptions, and generated millions of dollars in inflated management and performance fees.[56]

The SEC's complaint charged the defendants with committing and/or aiding and abetting violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Section 206 of the Advisers Act and Rule 206(4)-8 thereunder and, as to Balboa, Section 17(a) of the Securities Act.[57] De Charsonville was also charged with violating FINRA Rule 5210.[58] As to both defendants, the SEC's complaint sought a permanent injunction against future violations, disgorgement of ill-gotten gains plus prejudgment interest, and monetary penalties.[59]

The United States Attorney's Office for the Southern District of New York, which conducted a parallel investigation of this matter, also announced the arrest of Balboa and the simultaneous filing of a criminal complaint against him.[60]

2. SEC v. Welliver

On October 18, 2011, the SEC filed a civil injunctive action in the U.S. District Court for the District of Minnesota against David B. Welliver and his hedge fund advisor firm, Dblaine Capital, LLC ("Dblaine Capital").[61]

The SEC's complaint alleges that Welliver and Dblaine Capital obtained $4 million in loans pursuant to an improper, undisclosed quid pro quo agreement entered into in breach of their fiduciary duties to the Dblaine Fund (the "Fund").[62] Specifically, the SEC alleged that, in exchange for the loans, Welliver and Dblaine Capital committed to invest the Fund's assets in an illiquid private placement offering by Semita Partners, LLC ("Semita") recommended by the lender.[63] Because Welliver purportedly knew that the Fund's holdings were illiquid securities with no readily available market price, the SEC alleged that the Fund should have valued the Semita units at fair value pursuant to policies approved by the Fund's Board of Trustees.[64] However, according to the complaint, Welliver simply valued the holdings at their cost upon acquisition of $1 per unit for a total value of $900,000, and for a period of six months never made any attempt to calculate their fair value, which was actually $0.[65] The SEC alleged that, as a result, Welliver and Dblaine Capital caused the Fund to offer, sell, and redeem shares at an inflated net asset value.[66]

The complaint alleged that, as a result of their misconduct, Welliver and Dblaine Capital violated Section 17(a) of the Securities Act; Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; Section 206 of the Advisers Act and Rule 206(4)-8 thereunder; and Sections 17(a)(2), 17(e)(1), 22(e), and 34(b) of the Investment Company Act and Rules 22c-1 and 38a-1 thereunder.[67]

The SEC is seeking permanent injunctions, disgorgement of ill-gotten gains, including prejudgment interest, and civil penalties.[68] The investigation is ongoing.

D. Ponzi Schemes

Ponzi schemes continue to be a focus area for the SEC. In the last quarter of 2011 alone, the SEC filed over a dozen Ponzi-scheme related complaints, and initiated a similar number of administrative actions. As we have previously discussed, criminal prosecution of these cases can result in lengthy sentences, even for relatively 'small' Ponzi schemes, such as the 30-year prison term – the statutory maximum – imposed on Matthew Pizzolato for his involvement in a $20 million Ponzi scheme.[69]

1. SEC v. Management Solutions, Inc.

On December 15, 2011, the SEC obtained a temporary restraining order and emergency asset freeze in an alleged $220 million real estate-based offering fraud and Ponzi scheme masterminded by

Wendell and Allen Jacobson through their company, Management Solutions, Inc. ("Management Solutions"), a hedge fund advisor.[70] The SEC alleged that the Jacobsons offered investment opportunities in limited liability companies in order to share ownership of large multi-unit apartment communities. The Jacobsons utilized various funds that they created, including Caddis Partners, LLC, as a means to aggregate smaller investments from other entities created by the Jacobsons, prior to their funneling the funds to Management Solutions.[71]

In order to induce investments, the Jacobsons represented to investors that they purchased apartment complexes with low occupancy rates at steep discounts, renovated the properties, improved their management, and attempted to resell the properties within five years.[72] Investors were also allegedly told that the Jacobsons had never lost money on a property, except for one instance, and that on that one occasion the Jacobsons covered the loss personally so investor returns would not be affected.[73] Finally, the SEC claims that investors were told that they could expect profits from two sources – rental income from the complexes as well as profit on the eventual sales of the complexes – when, in reality, the money would come from new investors.[74]

The SEC charged Management Solutions and the Jacobsons with violations of Sections 5(a), 5(c), and 17(a) of the Securities Act; and Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder. The SEC seeks preliminary and permanent injunctions, disgorgement with prejudgment interest thereon, and civil monetary penalties.

2. SEC v. Fry

The SEC charged two hedge fund managers and a hedge fund advisor with various violations of securities fraud associated with the Ponzi scheme operated by Minnesota businessman Thomas Petters.[75]

In 2009, Petters was convicted of running a multi-billion dollar Ponzi scheme in which he used his company, Petters Company Inc. ("PCI"), to induce investors to give him money that he said would finance the purchase of consumer good shipments (the "Petters Ponzi Scheme"). Petters represented to investors that PCI would resell the merchandise at a profit to certain "Big Box" retailers, including Sam's Club and Costco. In reality, there were no purchases and resales of consumer merchandise. Rather, the transactions were fictitious.[76]

Among those who the SEC alleges facilitated the Petters Ponzi Scheme are hedge fund advisor Arrowhead Capital Management LLC ("Arrowhead"), its CEO, James Fry, and hedge fund manager Michelle Palm. The SEC claims that Arrowhead, Fry and Palm earned more than $42 million from three hedge funds they controlled that sent about $600 million in investor money to Petters.[77] According to the SEC's complaint, "[f]rom 1998 through 2008, the defendants funneled money into the Petters Ponzi Scheme by selling interests in the funds to investors."[78] The SEC claimed that the three defendants did so by misrepresenting material facts about the hedge funds and how they interacted with PCI.[79] Among the misrepresentations were: (i) stating that the funds were receiving distributions of profits directly from merchandise sales to the "Big Box" retailers when in reality monies always came directly from Petters and never came from merchandise sales to any retailers; (ii) failing to disclose to investors that Petters was experiencing difficulties in distributing those so-called profits; and (iii) representing to investors that independent accountants conducted quarterly examinations of the funds when no such examinations were ever conducted. The SEC further alleged that the Arrowhead hedge funds invested virtually all investor contributions in the Petters Ponzi Scheme.[80]

The SEC's complaint charges Fry, Palm, and Arrowhead, with violations of Section 17(a) of the Securities Act and aiding and abetting violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The complaint also charges Fry with violations of Section 10(b) of the Exchange Act and

Rule 10b-5 thereunder; and charges Arrowhead with violating Section 206(4) of the Advisers Act and Rule 206-4(8) thereunder. The complaint charges Fry and Palm with aiding and abetting violations of the Advisers Act and Rule 206-4(8) thereunder. The SEC seeks entry of a court order of permanent injunction against Fry, Palm, and Arrowhead, as well as an order of disgorgement, including prejudgment interest and penalties.

On November 17, 2011, a judgment of permanent injunction was entered against Palm, permanently enjoining her from future violations of the antifraud provisions of the Securities Act, the Exchange Act, and the Advisers Act. Subsequently, on February 16, 2012, the SEC issued an order instituting administrative proceedings against Palm pursuant to Section 203(f) of the Advisers Act (the "Administrative Order"). Based on that Administrative Order, Palm was barred from being associated with an investment adviser, broker, dealer, municipal securities dealer, or transfer agent.

Both Fry and Palm have been charged criminally in connection with the same misconduct. Palm pleaded guilty to one count of securities fraud and one count of making false statements to SEC staff during investigative testimony.

E. Fraudulent Misrepresentations

The SEC also continues to bring actions against hedge fund managers who lure investors with false and misleading marketing materials and other misrepresentations. These misrepresentations often focus on misstatements regarding a fund advisor's or manager's past and current performance, investment strategy, or professional credentials. A current example is described below.

In *SEC v. Kapur*,[81] the SEC filed a civil injunction action charging an unregistered hedge fund adviser Lilaboc, LLC d/b/a ThinkStrategy Capital Management, LLC ("ThinkStrategy"), and its sole managing principal, Chetan Kapur, with deceptive conduct concerning two hedge funds that they managed and advised: ThinkStrategy Capital Fund (the "Capital Fund") and TS Multi-Strategy Fund (the "Multi-Strategy Fund"). The complaint alleged that over a seven year period ThinkStrategy and Kapur deliberately deceived investors with false information "concerning the funds' investment performance, longevity, assets, and the credentials and experience of ThinkStrategy's management team."[82] For example, with respect to the Capital Fund Class A ("Capital Fund-A") shares, ThinkStrategy allegedly reported positive annual returns every year from 2003 to 2008, when in fact in most years, the fund sustained significant losses.[83] Moreover, according to the complaint, "[e]ven though Capital Fund-A had liquidated by late-2006 and ceased all trading by early 2008, ThinkStrategy continued reporting overstated results for its Capital Fund-A shares through the first quarter of 2009."[84] The complaint further alleged that ThinkStrategy and Kapur misrepresented the size and credentials of ThinkStrategy's management team.[85]

Regarding the Multi-Strategy Fund, which was a fund of hedge funds, ThinkStrategy and Kapur represented to investors that the firm conducted comprehensive due diligence on the portfolio managers of the hedge funds selected for investment.[86] For example, Kapur allegedly told at least one investor that ThinkStrategy performed "thorough due diligence" and "background checks" on all fund managers, and that all funds were required to have audited financial statements.[87] ThinkStrategy, however, consistently failed to conduct the thorough due diligence it promised investors.[88] The SEC alleged that, as a result, "the Multi-Strategy Fund made investments in several hedge funds that were later revealed to be Ponzi schemes or other serious frauds. Had ThinkStrategy required audited financial statements certified by bona fide accounting firms, as represented to investors, the Multi-Strategy Fund may not have invested detrimentally in those funds."[89]

The SEC's complaint charged ThinkStrategy and Kapur with violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. The complaint also sought permanent injunctions,

disgorgement and prejudgment interest thereon, and civil monetary penalties against ThinkStrategy and Kapur.[90] ThinkStrategy and Kapur consented to a judgment "permanently enjoining them from violating the above mentioned provisions, imposing a civil monetary penalty, and ordering them to pay disgorgement and prejudgment interest in amounts to be determined by the Court upon motion of the Commission."[91] In addition, "Kapur . . . consented to the entry of an SEC order barring him from association with any investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization."[92]

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[1] ABA No-Acton Letter (Dec. 8, 2005); http://www.sec.gov/divisions/investment/noaction/aba120805.htm.

[2] The temporary exemption extends the former federal private adviser exemption. The temporary exemption applies to an adviser who (1) does not hold itself out generally to the public as an investment adviser, (2) during the course of the preceding twelve months has had fewer than 15 clients, (3) does not act as an investment adviser to any investment company registered under the Investment Company Act, or a company that has elected to be a business development company pursuant to the Investment Company Act, and (4) either (i) has under $25 million of assets under management or (ii) provides investment advice to only venture capital companies. The full text of the temporary extension is available **here**.

[3] *Auriga Capital Corp. v. Gatz Properties, LLC*, 2012 Del. Ch. LEXIS 19 (January 27, 2012).

[4] *Id.* at 29.

[5] *Id.*

[6] Full Text of President Obama's economic speech in Osawatomie, Kans. (published December 6, 2011), *available at* http://www.washingtonpost.com/politics/president-obamas-economic-speech-in-osawatomie-kans/2011/12/06/gIQAVhe6ZO_print.html (last accessed March 23, 2012).

[7] A withholdable payment is defined to mean, subject to certain exceptions: (i) any payment of interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income, if such payment is from sources within the United States; and, (ii) any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the United States.

[8] In Re: Libor-Based Financial Instruments Antitrust Litigation, No. 11-md-2262 (S.D.N.Y.).

[9] Wachovia Bank, N.A., et al. v. VCG Special Opportunities Master Fund, Ltd., 661 F.3d 164 (2d Cir. 2011).

[10] In re Burton W. Wiand, No. 8:10-CV-71-T-17MAP (M.D. Fla. 2011).

[11] Parrott, et al. v. Logos Capital Mgmt., LLC, et al., Index no. 602400/08, 2012 NY Slip Op. 00125 (N.Y. App. Div. Jan. 12, 2012).

[12] Steinhardt, et al. v. Howard-Anderson, et al., C.A. No. 5878–VCL, 2012 WL 29340 (Del. Ch. Jan. 6, 2012).

[13] Speech by SEC Chairman: Remarks at the Practicing Law Institute's SEC Speaks by Chairman Mary L. Schapiro, U.S. Securities and Exchange Commission, Washington D.C. (Feb. 24, 2012); Select SEC and Market Data Fiscal 2011, available at http://www.sec.gov/about/secstats2011.pdf.

[14] Select SEC and Market Data Fiscal 2011, available at http://www.sec.gov/about/secstats2011.pdf.

[15] Jean Eaglesham, SEC Ups Its Game to Identify Rogue Firms, The Wall Street Journal (Dec. 27, 2011).

[16] SEC Press Release 2011-252 (Dec. 1, 2011), available at http://www.sec.gov/news/press/2011/2011-252.htm.

[17] *Id.*

[18] *Id.*

[19] Jean Eaglesham, SEC Ups Its Game to Identify Rogue Firms, The Wall Street Journal (Dec. 27, 2011).

[20] Grant McCool, FBI Sees More Hedge Fund Trading Probe Informants, Reuters (Feb. 27, 2012).

[21] The civil case is SEC v. Adondakis, No. 12-CV- 0409 in the U.S. District Court for the Southern District of New York. Separate criminal charges were also brought against the seven hedge fund managers. Spyridon Adondakis, Sandeep Goyal, Jesse Tortora have each pleaded guilty to those charges and are reported to be cooperating with the government.

[22] Complaint at ¶ 2, 5.

[23] SEC Litig. Release No. 22230 (Jan. 19, 2012), http://www.sec.gov/litigation/litreleases/2012/lr22230.htm. See also Complaint at ¶¶ 6-7.

[24] Complaint at ¶¶ 10-13.

[25] SEC Litig. Release No. 22230 (Jan. 19, 2012), http://www.sec.gov/litigation/litreleases/2012/lr22230.htm. Mr. Whitman was also charged in a related criminal case.

[26] *Id.*

[27] *Id.*

[28] *Id.*

[29] The civil case is SEC v. Adondakis, No. 12-CV- 0409 in the U.S. District Court for the Southern District of New York.

[30] Complaint at ¶ 1.

[31] *Id.* at ¶ 2.

[32] SEC Litig. Release No. 22257 (Feb. 10, 2012), http://www.sec.gov/litigation/litreleases/2012/lr22257.htm.

[33] *Id.*

[34] The civil case is SEC v. Longoria, No. 11-CV- 0753 in the U.S. District Court for the Southern District of New York.

[35] SEC Litig. Release No. 21836 (Feb. 3, 2011), http://www.sec.gov/litigation/litreleases/2011/lr21836.htm.

[36] SEC Litig. Release No. 21844, (Feb. 8, 2011), http://www.sec.gov/litigation/litreleases/2011/lr21844.htm.

[37] Amended Complaint at ¶ 4.

[38] *Id.* at ¶¶ 37-98.

[39] *Id.* at ¶ 6.

[40] *Id.*

[41] *Id.*

[42] *Id.*

[43] *Id.*

[44] *Id.*

[45] *Id.*

[46] *Id.*

[47] In December 2010, Pflaum pleaded guilty to conspiracy and securities fraud in a parallel criminal case arising from the same conduct. U.S. v. Pflaum, 11 Cr. 01265 (JGK) (S.D.N.Y. 2010).

[48] *Id.*

[49] In July 2011, Shimoon pleaded guilty to conspiracy and securities fraud in a parallel criminal case arising from the same conduct. U.S. v. Shimoon, 11 Cr. 00032 (JSR) (S.D.N.Y. 2011).

[50] *See* SEC Litig. Release No. 22153 (Nov. 15, 2011), http://www.sec.gov/litigation/litreleases/2011/lr22153.htm (Longoria and Longueuil), SEC Litig. Release No. 22236 (Jan. 25, 2012), http://www.sec.gov/litigation/litreleases/2012/lr22236.htm (Freeman, Nguyen, and Barai), and SEC Litig. Release No. 22270 (Feb. 24, 2012), http://www.sec.gov/litigation/litreleases/2012/lr22270.htm (Pflaum and Shimoon).

[51] The civil case is SEC v. Balboa, 11-cv-8731 in the U.S. District Court for the Southern District of New York.

[52] SEC Litig. Release No. 22176 (Dec. 2, 2011), http://www.sec.gov/litigation/litreleases/2011/lr22176.htm.

[53] *Id.*

[54] Complaint at ¶¶ 30-32.

[55] *Id.* at ¶ 4.

[56] *Id.*

[57] *Id.* at ¶ 5.

[58] *Id.*

[59] *Id.* at ¶ 7.

[60] SEC Litig. Release No. 22176 (Dec. 2, 2011), http://www.sec.gov/litigation/litreleases/2011/lr22176.htm. The criminal case is U.S. v. Balboa, 11-mag-3038 in the U.S. District Court for the Southern District of New York.

[61] The civil case is SEC v. Welliver, No. 0:11cv3076 (RHK/SER) in the U.S. District Court for the District of Minnesota.

[62] SEC Litig. Release No. 22131 (Oct. 18, 2011), http://www.sec.gov/litigation/litreleases/2011/lr22131.htm.

[63] Complaint at ¶¶ 50-54.

[64] *Id.* at ¶¶ 69-70.

[65] *Id.* at ¶ 70, 74.

[66] *Id.* at ¶ 80.

[67] *Id.* at ¶¶ 8-9.

[68] *Id.* at ¶ 10.

[69] U.S. v. Pizzolato, No. 10-30729 (5th Cir. 2011).

[70] The civil case is S.E.C. v. Management Solutions, Inc., No. 11-cv-01165 in the U.S. District Court for the District of Utah; SEC Litig. Release No. 22195 (Dec. 15, 2011), http://www.sec.gov/litigation/litreleases/2011/lr22195.htm.

[71] Complaint at ¶ 22.

[72] *Id.* at ¶ 2.

[73] *Id.* at ¶ 33.

[74] *Id.* at ¶ 5.

[75] The civil case is S.E.C. v. James Fry in the U.S. District Court for the District of Minnesota, available at http://www.sec.gov/litigation/litreleases/2011/comp-pr2011-237.pdf.

[76] Petters is currently serving a 50-year prison sentence.

[77] Complaint at ¶ 1, 5-6.

[78] *Id.* at ¶ 5.

[79] *Id.* at ¶¶ 7-9.

[80] *Id.* at ¶ 5.

[81] The civil case is SEC v. Kapur, No. 11-CIV-8094 in the U.S. District Court for the Southern District of New York.

[82] Complaint at ¶ 2.

[83] *Id.* at ¶¶ 22-24.

[84] *Id.* at ¶ 20.

[85] *Id.* at ¶ 49.

[86] *Id.* at ¶ 58.

[87] *Id.* at ¶ 59.

[88] *Id.* at ¶ 60.

[89] *Id.* at ¶ 62.

[90] SEC Litig. Release No. 22151 (Nov. 10, 2011), http://www.sec.gov/litigation/litreleases/2011/lr22151.htm.

[91] *Id.*

[92] *Id.*