Ropes & Gray's Hedge Fund Update: August 2011

The following summarizes recent legal developments of note affecting the hedge fund industry:

Five European Nations Issue Temporary Bans on Short Selling

In early August, financial regulators from five European countries issued orders temporarily banning short sales of shares of certain financial industry issuers in response to extraordinary volatility in the financial markets, and in particular to the sharp declines in the value of many European bank stocks. France, Spain, Belgium and Italy each issued short-selling bans, which have similar features. Each of these bans, except for Belgium's, is temporary and initially was in effect for 15 days from the date the order was issued. However, the bans have been renewed so that short selling will not be permitted in Italy and Spain until after September 30, 2011. The ban in France could last as long as November 11, 2011. Belgium's ban will apply for an indefinite period. In addition to these coordinated bans, Greece reintroduced a ban on short-selling of shares listed on the Athens Exchange. The Greek ban is scheduled to expire October 7, 2011.

The Spanish ban forbids investors from entering into any transaction which might constitute or increase a net short position on sixteen enumerated Spanish financial stocks. The ban covers trades on equities or indices, including cash equities transactions, derivatives in regulated markets or OTC derivatives. Positions arising from market making activities are exempted from ban. The ban generally describes such market making activities as the activities of investment firms involved in transitory or intraday net short positions for the purpose of either hedging client orders or providing quotes for bid and ask prices on a continuous basis.

The French ban forbids the creation of any new net short position and forbids investors from increasing any existing net short position in the equity shares or securities of ten French financial industry issuers. When calculating a net short position for these purposes, derivatives contracts should be included but borrowed or loaned securities should not. The ban does not apply to financial intermediaries acting as market makers or liquidity providers. The French regulator has clarified that "marginal" net short positions in securities of such issuers through index derivatives are generally not prohibited by the French ban, if such index derivatives are used to hedge general market risk of investing in equities.

Under the Italian order, investors are prohibited from taking new net short positions or increasing existing net short positions with respect to shares of 29 issuers listed on the Italian regulatory authority's website. According to an FAQ released by the Italian regulator, the calculation of a net short position must include all types of financial instruments whose value is linked to the values of the shares of a given issuer, and lists ETFs, ADRs, options, swaps, futures and contracts for differences. Similar to the Spanish ban, the Italian ban does not apply to market makers or specialists. The Italian regulator has issued guidance similar to the guidance issued by the French regulatory with respect to index derivatives.

Belgium, which had previously banned naked shorting of the shares of four enumerated financial issuers, extended the regulatory definition of "uncovered transactions" so that coverage with borrowed shares is no longer considered "full coverage." As a result, covered shorting is now prohibited. Existing net economic short positions are not covered by the Belgian ban, but such positions may not be increased.

Greece's ban is an absolute ban which applies to all shares listed in the Athens Exchange regardless of the venue where a transaction is executed (*e.g.*, regulated markets, multilateral trading facilities or over-the-counter) and applies to both naked and covered short sales, including sales which are settled with subsequent intraday purchases. The ban provides an exemption for certain registered market makers and does not prohibit market participants from obtaining or increasing short exposure through listed or over-the-counter derivatives.

EU Directive on Alternative Investment Fund Managers

On July 1, 2011, the *European Union Directive on Alternative Investment Fund Managers* (the "Directive") was published in the Official Journal of the European Union after several months of delay. While the Directive was released in final form on May 13, 2011 and approved by the European Union Council on May 27, 2011, publication in the Official Journal makes the Directive official and triggers Member States' two year period with which to comply. The Directive took effect 20 days after publication and each Member State has until July 22, 2013 to pass the Directive into national law.

In addition, on July 13, the European Securities and Markets Authority ("ESMA") responded to a request from the European Commission to provide to it advice on implementing the Directive (the "Draft Advice"). ESMA has requested response to its consultation paper by September 13, 2011, and it intends to finalize its advice to the Commission by November 16, 2011. Additionally, ESMA will hold an opening hearing on its Draft Advice on September 2, 2011 in Paris.

ESMA's consultation paper covers three areas:

- General provisions, authorization, and operating conditions – issues including which managers fall under the Directive and how assets under management are calculated for these purposes, initial capital and seed money, conflicts of interest, risk management, investment in securitization positions, valuation, delegation of manager functions and organizational requirements
- Depositaries – governance of depositaries to alternative investment funds, appointment of the depositary, duties of a depositary, depositary liability
- Transparency requirements and leverage – including the definition of leverage and methods of calculation, the content and format of the annual report to be prepared by the manager, disclosure to investors, the use of information by competent authorities, and limits on leverage

The Draft Advice tries to align the requirements with respect to general operation conditions with existing provisions in previous directives which cover retail funds.

The rules governing depositaries have been the subject of much political scrutiny, and the Directive delegates authority to the European Commission to issue more detailed rules on the subject. ESMA is consulting on whether custodians should be liable for the actions of their sub-custodians, and on the role of the custodian in overseeing its sub-custodians, including prime brokers when they are holding collateral.

ESMA's paper also highlights the Directive's goal of increasing transparency of managers to both regulators and investors. One part of this section that may be contentious is the disclosure of fees in the annual report. Significantly, ESMA has proposed that all managers be required to make quarterly reports to the authorities.

The fourth area that ESMA will address in the future is supervision. However, these measures are less urgent because they relate to the introduction of a passport for third country entities, which will not be operational until at least July 2015. Thus, this advice will come in a separate consultation letter to be published for comment later this summer.

SEC Adopts Final Rule for Large Trader Reporting System

The Securities and Exchange Commission ("SEC") has adopted a large trader reporting system that will require "large traders" to identify themselves to the SEC and provide the SEC with information about their businesses and their affiliates. The new system also imposes recordkeeping, reporting and limited monitoring requirements on broker-dealers that hold accounts for large traders. The large trader system was adopted substantially as it was proposed in April 2010, though we have noted some key differences between the proposed and final rules below. Our more detailed alert on the proposed system, including Rule 13h-1 under the *Securities Exchange Act of 1934* (the "Exchange Act") and new Form 13H, can be found here. The adopting release for the large trader reporting system can be found here.

Very generally, a large trader is a person that exercises investment discretion over one or more accounts where the aggregate transactions in NMS securities across such accounts equal or exceed 2 million shares or $20 million during any calendar day, or 20 million shares or $200 million during any calendar month. The rule prohibits a trader from disaggregating accounts and trading activity, by effecting trades through multiple broker-dealers, accounts or transactions, for purposes of avoiding the large trader identification and reporting requirements. In addition, if two traders engage in a coordinated trading strategy with the effect of exercising joint investment discretion over their individual accounts, the rule requires each trader to include all transactions in these joint accounts in their respective activity level calculations. Each large trader will be required to file Form 13H with the SEC at least annually, although updating amendments will be required to be filed no later than the end of any calendar quarter in which any of the information previously filed on the form becomes inaccurate.

Large traders will be assigned identification numbers by the SEC that must be provided to broker-dealers. Broker-dealers, in turn, generally will be required to maintain records regarding the purchases and sales of NMS securities by large traders and provide information to the SEC about transactions in NMS securities that exceed the minimum reporting activity level established in the rule (generally, any transaction involving 100 or more shares). In addition, although large traders are principally responsible for identifying themselves as large traders, broker-dealers have some responsibility to monitor their customers and identify any person that should have identified itself as a larger trader and has not done so (an "Unidentified Large Trader").

The following is a summary of the key differences between the proposed large trader reporting system and the adopted system:

- For the purpose of determining whether a person has engaged in sufficient trading activity to be classified as a large trader, the SEC clarified that the rule focuses on transactions involving investment decisions traditionally associated with trading in NMS securities and added transactions involving business combinations to the list of excluded transactions.

- In order to mitigate the need for traders to actively monitor their trading levels, the SEC will permit persons who expect to meet or exceed the large trader activity level in the future to voluntarily register as large traders on Form 13H.

- Changes were made to final Form 13H for the purpose of decreasing the burden of the filing. For instance, large traders will be required to disclose only those affiliates who exercise investment discretion over NMS securities, and not affiliates who merely beneficially own NMS securities. Also, in place of the proposed requirement to disclose all affiliates, large traders will be required to attach an organizational chart to help the SEC understand the large trader's corporate structure.

- The SEC clarified that broker-dealers generally will have until the opening of business on the day following a request from the SEC to submit transaction information, except in unusual circumstances where same-day information is requested.

- The SEC clarified that when monitoring for Unidentified Large Traders, as long as the broker-dealer does not have actual knowledge that a person is an Unidentified Large Trader, the broker-dealer need only consider transactions with such broker-dealer and it need not proactively investigate a person's trading activity levels with other broker-dealers.

Large traders will have to identify themselves to the SEC beginning December 1, 2011 and broker-dealers will have until April 30, 2012 to comply with their recordkeeping, reporting and monitoring obligations under the rule.

SEC Proposes Rules to Disqualify "Bad Actors" from Reliance on Rule 506 Private Placement Safe Harbor

The SEC has proposed new regulations under Section 926 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* that would disqualify certain "bad actors" from relying on Rule 506, the most widely used safe harbor for private placements. The proposed rules reflect the Dodd-Frank Act's directive to the SEC to issue disqualification rules for Rule 506 offerings that are "substantially similar" to those for Regulation A offerings while expanding the list of disqualifying events to include certain actions taken by state securities regulators.

Persons covered by the disqualification rules. The SEC's proposal designates the following as "Covered Persons," the acts of whom could disqualify an issuer from relying on Rule 506:

- the issuer, any predecessor of the issuer, or an affiliated issuer;
- any director, officer, general partner or managing member of the issuer;
- any beneficial owner of 10% or more of any class of the issuer's equity securities;
- any promoter connected with the issuer in any capacity at the time of sale;
- any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with sales of securities in the offering; and
- any director, officer, general partner, or managing member of any such compensated solicitor.

The investment adviser to a private fund is not named as a Covered Person. The SEC's proposal solicits comment on whether the investment adviser to a private fund issuer should be made subject to the disqualification regime. However, several comments pointed out that without further tailoring by the SEC, the definition of "promoter" under Rule 405, which includes "any person who…directly or indirectly takes initiative in founding and organizing the business or enterprise of an issuer," may be broad enough to encompass an investment adviser.

While the status of investment advisers under the proposal is uncertain, the release is clear that actions of placement agents and other intermediaries can disqualify a Rule 506 offering. When coupled with the broad definition of the term "officer" (defined under Rule 405 to include "a president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any person routinely performing corresponding functions with respect to any organization"), the proposed rule might cover large numbers of employees at institutions acting as placement agents, including employees that have not had any involvement with the relevant Rule 506 offering. The proposal therefore requested comment on whether the definition of "officer" should be restricted to those performing policy-making functions for a Covered Person, or whether disqualification should attach only to officers actually involved with the relevant offering.

Acts or events that trigger disqualification. The proposed rule would disqualify an offering from reliance on Rule 506 if a Covered Person is subject to any of the following:

- A felony or misdemeanor conviction within ten years of the proposed sale (i) in connection with the purchase or sale of any security, (ii) involving the making of any false filing with the SEC, or (iii) arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities.
- A court order, judgment or decree entered within five years of the proposed sale that, at the time of the sale, restrains or enjoins a Covered Person from engaging in any conduct or practice (i) in connection with the purchase or sale of any security, (ii) involving the making of any false filing with the SEC, or (iii) arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities.
- A final order of a federal or state securities, banking, or insurance regulator (i) that, at the time of the proposed sale, bars the Covered Person from associating with other entities under the supervision of the regulator or engaging in the business of securities, insurance, or banking, or (ii) that is based on a violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct and was entered within ten years of the proposed sale.
- An SEC disciplinary order that, at the time of the proposed sale, (i) suspends or revokes a Covered Person's registration as a broker, dealer, municipal securities dealer or investment adviser, (ii) places limits on the activities, functions or operations of a Covered Person, or (iii) bars the Covered Person from association with any entity or from participating in the offering of any penny stock.
- Suspension or bar from membership in, or suspension or bar from association with a member of, a national securities exchange or a national or affiliated securities association at the time of the proposed sale, for any action or inaction constituting conduct inconsistent with just and equitable principles of trade.
- Filing as registrant or issuer, or being named as an underwriter in, a Regulation A offering that, within five years of the proposed sale, has been the subject of a refusal order, stop order, or order suspending the Regulation A exemption.
- A U.S. Postal Service false representation order entered within five years of the proposed sale or certain preliminary injunctions sought by the U.S. Postal Service and in effect at the time of such sale.

Under the proposed rule, the foregoing would disqualify an offering from reliance on Rule 506 even where the event occurred prior to the enactment of the Dodd-Frank Act or to the date the new rules become effective. This retroactive effect may be particularly troublesome for issuers whose continued reliance on Rule 506 is threatened by disqualifying events attributed to a 10% owner of the issuer's securities. Even where private funds have the authority in their offering documents to compulsorily redeem such an investor, this may not be a practical course of action.

Exemption for issuers that exercise reasonable care. The proposed rule includes an exemption from Rule 506 disqualification where the issuer can establish "that it did not know, and in the exercise of reasonable care could not have known" that a Covered Person had been the subject of a disqualifying event. The proposal goes on to state that an issuer seeking to avail itself of this exemption "will not be able to establish that it has exercised reasonable care unless it has made factual inquiry into whether any disqualifications exist" and that "[t]he nature and scope of the requisite inquiry will vary based on the circumstances of the issuer and the other offering participants."

The proposal states that, in some instances, representations in agreements or other negative consent received from Covered Persons may be sufficient to prove that the issuer exercised reasonable care, but also warns that "[i]ssuers should also consider whether investigating publicly available databases is reasonable" and that in certain undefined circumstances, "further steps may be necessary." While the Commission is likely to provide greater clarity on this exemption in its adopting release, comments to the proposal have expressed concern that the language used in the proposal could require issuers to engage in continuous, real-time monitoring for potential disqualifications with regard to all Covered Persons throughout the conduct of a Rule 506 offering.

Consequences of disqualification from reliance on Rule 506. Disqualification from reliance on the Rule 506 safe harbor does not automatically subject an offering to the requirements of a public offering. An issuer may still complete a private offering in reliance on Section 4(2) of the Securities Act, but because of the lack of bright-line rules under that section, such an offering is likely to be subject to substantial uncertainty. Furthermore, disqualification from the safe harbor may have the effect, under Section 18 of the Exchange Act, of eliminating the offering's exemption from state securities offering requirements.

Given the potential consequences of disqualification, fund managers should consider developing procedures for determining whether Covered Persons of continuously offered funds, including affiliates, placement agents, and significant investors have been subject to disqualifying events.

Timeline for adoption of final rule. The comment period for the proposed rule closed on July 14th. The SEC's timeline for implementing Dodd-Frank indicates the final rule will be adopted before the end of this year.

SEC Increases "Qualified Client" Dollar-Amount Thresholds for Performance Fee Rule

On July 12, 2011, the SEC issued an order increasing the dollar-amount thresholds used to determine whether an advisory client, or an investor in a private fund, is a "qualified client" that may be charged a performance fee by its investment adviser under Rule 205-3 under the Advisers Act.

Under the revised thresholds, a client/investor will satisfy the dollar-amount threshold to be a "qualified client" if the client/investor has at least $1 million under management with the adviser immediately after entering into the advisory contract or the adviser reasonably believes that the client/investor has a net worth of more than $2 million immediately prior to entering into the advisory contract. These increases from the current thresholds of $750,000 and $1.5 million, respectively, were adopted as a result of the Dodd-Frank Act's requirement that the SEC adjust these dollar-amount thresholds for inflation every five years beginning no later than July 21, 2011. Other provisions of Rule 205-3 that include among qualified clients "qualified purchasers" under the 1940 Act and persons with specified relationships with an adviser are unaffected by the order.

Advisers should update their client and investor questionnaires in light of these threshold changes, which become effective September 19, 2011.

Moreover, on May 10, 2011 the SEC proposed other changes to Rule 205-3 that, very generally, would exclude the value of a person's primary residence (and related mortgage debt) from the calculation of a client's net worth and provide a transition rule for existing performance fee arrangements that do not satisfy the new thresholds but (i) were permissible at the time the advisory contracts were entered into or (ii) were entered into by an investment adviser at a time when it was exempt from registration with the SEC. In its July 12, 2011 press release announcing the dollar threshold changes, the SEC staff indicated that the proposed amendments to Rule 205-3 are "currently under consideration."

CFTC Approves Anti-Manipulation and Anti-Fraud Rules

On August 15, 2011, the Commodity Futures Trading Commission's final rules expanding its ability to pursue fraud and manipulation claims in connection with any futures, swaps, or "contracts of sale of any commodity in interstate commerce" took effect. The new rules make clear that the CFTC intends to significantly enhance its enforcement capabilities. The new rules, which were among the first to be finalized by the CFTC under the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, implement Section 753 of the Dodd-Frank Act. Among other things, the new rules (i) eliminate the requirement in Section 6(c) of the *Commodity Exchange Act* that the CFTC prove that the alleged fraud or manipulation had an effect on price, and (ii) lower the scienter standard to recklessness for cases involving fraud-based manipulation.

New Rule 180.1 is modeled on Rule 10b-5 under the *Securities Exchange Act of 1934* and broadly prohibits manipulative and deceptive devices and contrivances – as well as *attempts* to use such devices and contrivances – in connection with any future, swap or "contract of sale of any commodity in interstate commerce," regardless of whether the conduct was intended to create or did create an artificial price. In contrast to the CFTC's prior enforcement authority, Rule 180.1 does not require proof of specific intent to defraud or manipulate, but instead extends to *reckless* conduct, thereby significantly lowering the CFTC's burden of proof. Rule 180.1 is evidently not limited to fraudulent conduct *in connection with* the purchase or sale of a future, swap, or contract of sale of any commodity in interstate commerce; rather, the CFTC has stated that it also extends to conduct in connection with, among other things, the "pendency" of a contract. Although Rule 180.1 does not explicitly impose any new affirmative duties of inquiry, diligence or disclosure, the CFTC's guidance provides that trading on the basis of material non-public information in breach of a pre-existing duty (established by another law or rule, agreement, understanding, or some other source), or trading on the basis of material non-public information that was obtained through fraud or deception, may nevertheless violate Rule 180.1.

In addition, in its release, the CFTC embraced the *Bank of New England* "collective knowledge" standard for organizational liability, which permits the conduct of one corporate agent to be aggregated with another corporate agent's state of mind in order to hold the corporation liable for fraud. The CFTC's embrace of "collective knowledge," along with the other elements of Rule 180.1, increase significantly the importance of an effective compliance program. Finally, with respect to penalties under Rule 180.1, the CFTC will follow CEA Section 6(c)(10)(C)(ii), which provides that the CFTC may assess an amount equal to the greater of $1 million or triple the monetary gain for each such violation.

New Rule 180.2, which is more in line with the CFTC's scope of power before the Dodd-Frank Act, codifies the CFTC's long-standing authority to prohibit price manipulation by making it unlawful for any person, directly or indirectly, to manipulate or attempt to manipulate the price of any futures, swaps or any "commodity in interstate commerce." In contrast to Rule 180.1, *specific intent* is required under Rule 180.2 The rule's application will be guided by the traditional four-part test for manipulation that has developed in the case law, which considers whether (1) the accused had the ability to influence market prices; (2) the accused specifically intended to create or effect a price or price trend that does not reflect legitimate forces of supply and demand; (3) artificial prices existed; and (4) the accused caused the artificial prices.

IRS Notice Defers Commencement Date of FFI Withholding Tax

The Internal Revenue Service (IRS) has issued Notice 2011-53 (the "Notice"), which provides a modified timeline for the implementation of the new reporting and withholding requirements enacted by the *Hiring Incentives to Restore Employment Act of 2010* (the "HIRE Act"). The Notice defers the commencement date of the withholding tax applicable to "foreign financial institutions" ("FFIs") and non-financial foreign entities from January 1, 2013 to (i) January 1, 2014 for U.S. source fixed or determinable, annual or periodical (FDAP) income and (ii) January 1, 2015 for all other payments subject to HIRE Act withholding (such as gross proceeds from the disposition of securities that could produce U.S. source interest and dividends). The Notice provides that in order to avoid the withholding tax beginning January 1, 2014 and in order to be treated as a "participating FFI", an FFI must enter into an agreement with the Secretary of the Treasury as required by the HIRE Act ("FFI Agreement") by June 30, 2013 (rather than January 1, 2013, as previously required). Any FFI that enters into an FFI Agreement after June 30, 2013 and prior to January 1, 2014 will also be treated as a participating FFI but may not be identified as such in time to avoid being withheld on. The Notice also simplifies the first year of information reporting that is required to be provided to the IRS by an FFI under an FFI agreement.

Other Developments

We recently published the following separate Alerts of interest to the hedge fund industry:

Massachusetts Adopts New Regulations on the Use of Expert Network Services
August 24, 2011

Broker-Dealer/Adviser Sanctioned for Inadequate Insider Trading Procedures
July 14, 2011

Update on Commodity Pool Operator Registration Exemptions
July 7, 2011

SEC Adopts Final Rule Defining Family Offices Exempt from SEC Registration
June 24, 2011

SEC Adopts Rules to Implement the Private Fund Investment Advisers Registration Act
June 23, 2011

CFTC Proposes Temporary Exemptions from Certain New OTC Swap Laws
June 15, 2011

For further information, please contact the Ropes & Gray attorney who normally advises you.