Ropes & Gray's Hedge Fund Update: December 2011

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

U.S. Developments

SEC Files Enforcement Actions Targeting "Suspicious Investment Returns"

On December 1, 2011, the SEC announced four separate enforcement actions as part of a new initiative—the "Aberrational Performance Inquiry"—to combat fraud by identifying "abnormally" high-performing funds and targeting them for greater scrutiny. The four complaints, filed between November 9 and December 1, allege a range of securities violations, including inflating the value of fund holdings, purposefully concealing fund performance, and misrepresenting critical fund attributes such as liquidity, investment strategy, manager credentials, and conflicts of interest. These are the first enforcement actions the SEC has attributed to this new investigative approach.

Under the initiative, the SEC's Asset Management Unit uses proprietary risk analytics to monitor hedge fund performance and identify what the SEC calls "outlier funds": those regularly reporting above-market returns and unexpectedly low volatility. The agency may also scrutinize funds whose record of performance appears inconsistent with their stated investment strategy or other relevant benchmarks. The agency has provided little detail about these analytics; the most concrete example was offered by Director of Enforcement Robert Khuzami in March, when he testified before Congress that the agency was focusing on funds that outperform market indexes by 3% or more on a regular basis.

This is the first time the SEC has attempted to continuously monitor funds for early warning signs of potential securities violations. A complementary program, the recently announced "Problem Advisers Initiative," also proactively monitors adviser compliance with securities laws through ongoing due diligence reviews of advisers' representations to investors related to their education, experience, and past performance. Under these new initiatives, potential minor violations may receive significant attention in an effort to identify and undercut schemes at their earliest stages. Khuzami has analogized the agency's new efforts to the "broken windows" policing strategy employed in New York City in the 1990s, which focused on stopping small crimes in order to prevent more serious ones.

Although the current actions target relatively egregious violations—with two of the actions initiated after the relevant funds collapsed and another after that fund refused to redeem its investors as promised—they represent a broader warning about the SEC's new, proactive methods. Accordingly, funds and managers should expect an increase in enforcement actions brought for lesser violations and should take care to avoid such problems, particularly by ensuring the accuracy of all statements about the fund, its strategy, and manager qualifications. In announcing these actions SEC officials also stated that this new analytics-based approach is being applied "across the investment adviser space – beyond performance and beyond hedge funds," and that an undisclosed number of additional hedge fund investigations remain ongoing.

New York City Considering an Attack on Carried Interest in the Context of the Unincorporated Business Tax ("UBT")

New York City's audit team is focusing on the treatment of carried interest in the context of the UBT. Very generally, unlike most jurisdictions, New York City imposes a direct tax on unincorporated entities (e.g., partnerships) with a presence in New York City. While management companies classified as partnerships for tax purposes pay this tax on their management fee income, historically many New York City managers

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earned carried interest through separate vehicles and took the position that the carried interest was exempt from the UBT. In addition to protecting the carried interest from tax, because the management company generally incurs the majority of a manager/carry expenses, this arrangement also concentrated the management/carry expenses (and hence the deductions) in the entity subject to UBT.

Unlike the proposed U.S. federal legislation, New York City does not appear to be focused on treating the carried interest as taxable income for UBT purposes. Instead, the City appears to be focused on shifting expenses from the management company/partnership to the carried interest vehicle. Such a shift has the effect of increasing a management company's UBT (because it has fewer deductions) without a corresponding offset in the related carry vehicle (which does not benefit from the deductions because it is not subject to the UBT). It is unclear whether New York City actually has the authority to make such an argument.

FinCEN Will Proceed with New Regulations Requiring Investment Advisers to Establish AML Programs

Last month, in a speech given at the American Bankers Association / American Bar Association's annual money laundering enforcement conference, the director of the Financial Crimes Enforcement Network ("FinCEN"), James H. Freis, Jr., announced that FinCEN would resume working on a regulatory proposal to require investment advisers to establish anti-money laundering ("AML") programs and to file suspicious activity reports ("SARs"). FinCEN first published such a proposal in the Federal Register in May of 2003 pursuant to its authority under the *Banking Secrecy Act*, but the proposal was withdrawn in November of 2008 after years of inaction on the matter. The renewed effort would incorporate the recent developments in financial regulation codified in the Dodd-Frank Act and its implementing rules promulgated by the SEC.

CFTC's Final Rule on Position Limits Challenged in Lawsuit by ISDA and SIFMA

On December 2, 2011, the International Swaps and Derivatives Association ("ISDA") and the Securities Industry and Financial Markets Association ("SIFMA") jointly filed a lawsuit against the Commodity Futures Trading Commission (the "CFTC") in the United States District Court for the District of Columbia and a petition for review in the U.S. Court of Appeals for the District of Columbia Circuit challenging the final rules establishing CFTC-administered speculative position limits for 28 energy, metals and agricultural commodity futures, options and swaps contracts (the "Final Rule"). The complaint represents the first legal challenge to a CFTC rule.

After a lengthy comment period and roughly 15,000 comment letters, the Final Rule was adopted by 3-2 vote on October 18, 2011 at a public meeting of the CFTC (the "Open Meeting") pursuant to recent amendments to the *Commodity Exchange Act* (the "CEA")[1], enacted under the financial reform regulatory regime of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act")[2]. Please see Ropes & Gray Alert Commodity Futures Trading Commission Announces Final Rule on Position Limits for Futures and Swaps for a more detailed description of the Final Rule.

The lawsuit generally alleges that, in adopting the Final Rule, the CFTC (i) misinterpreted its statutory authority and erroneously concluded that the CEA required the CFTC to establish position limits without discretion and specifically, without regard to whether they would be harmful to the U.S. economy, (ii) failed

[1] 7 U.S.C. §§ 1 et seq.
[2] 12 U.S.C. §5301 et seq.

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to make statutorily required findings before establishing the Final Rule and (iii) failed to consider the costs and benefits of the Final Rule prior to its promulgation, as is required under the CEA.

The lawsuit contends that the CEA authorized the CFTC to establish position limits only if the CFTC finds that they "are necessary to diminish, eliminate, or prevent" "an undue and unnecessary burden on interstate commerce" caused by "[e]xcessive speculation".[3] The lawsuit, quoting the Federal Register and statements by CFTC commissioners from the Open Meeting transcript, also argues that in relying on this flawed statutory interpretation, at least one CFTC commissioner voted for the Final Rule only because he mistakenly believed that establishment of position limits was required under the Dodd-Frank Act and CEA, and that the CFTC failed to consider evidence that excessive speculation is not an issue in the commodity markets.

ISDA and SIFMA asked that the Court of Appeals hold that the Final Rule is unlawful under the *Administrative Procedure Act*[4] and CEA. The complaint uses arguments similar to those made by the U.S. Chamber of Commerce and The Business Roundtable in their recent successful suit against the SEC over its new proxy access rule. The suit thus raises the possibility that the Final Rule, which becomes effective in 2012, may be delayed or struck down.

CFTC Approves New, More Restrictive Client-Funds Rules

In the wake of the MF Global bankruptcy, on December 5, 2011, the CFTC unanimously approved tighter restrictions on how futures brokerage firms can invest customer segregated funds, barring investment in foreign sovereign debt and in-house repurchase agreements and restricting the investment of customer funds in other investments, including money market mutual funds. Permitted investments include U.S. Treasury securities, municipal securities, and U.S. agency obligations, subject to concentration limits except in the case of U.S. Treasury securities.

The amended rule imposes the following new limits on how FCMs may invest customer segregated funds:

- **Foreign Sovereign Debt.** FCMs may no longer invest customer funds in foreign sovereign debt, although a firm may petition for an exemption from this limitation. In approving this restriction, the CFTC rejected assertions that investing in foreign sovereign debt is necessary to mitigate risks associated with foreign currency exposure, diversify holdings, or combat market volatility. More specifically, the risk of currency fluctuations does not justify holding foreign sovereign debt, which is also subject to fluctuations and is comparatively illiquid. In certain cases, however, the CFTC may grant an FCM's petition to invest in foreign sovereign debt if the brokerage has customer balances in that currency and the foreign debt serves to preserve principal and maintain liquidity.

- **In-House Repurchase Agreements.** FCMs may no longer invest customer funds in in-house repurchase agreements under any circumstances; they may, however, invest in repurchase agreements with third parties. The CFTC explained that this ban is necessary because in-house agreements are fundamentally different from third party agreements; in the former the cash and loan collateral are all controlled by a single entity, without external verification ensuring that payment follows delivery. As a result, in-house agreements have the potential to create significant conflicts of interest.

[3] 7 U.S.C. § 6a(a)(1).
[4] 5 U.S.C. §§ 551 et seq.

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- **MMMF Concentration Limits.** The amended rule also imposes asset-based concentration limits on various investments, particularly money market mutual funds ("MMMFs"). The new limits distinguish funds and management companies based on their total assets and impose different concentration limits depending on the type of MMMFs—Treasury-only or non-Treasury-only. Under the amended rule, FCMs cannot invest more than 10% of customer funds in MMMFs with less than $1 billion in fund assets and/or with management companies managing less than $25 billion in MMMF assets. An FCM may invest all of its customer funds in an MMMF meeting these size requirements, subject to additional limitations: No more than 50% of segregated funds may be invested in non-Treasury-only MMMFs; up to 100% of segregated funds may be invested in Treasury-only MMMFs meeting the size requirements. The rule also limits investment in any one non-Treasury-only fund or family of funds, capping investment in a single fund at 10% of customer funds and in any particular family of funds at 25%.

The CFTC clarified two technical requirements for investing in MMMFs. First, acknowledgement letters must be from a party with substantial control over the fund's assets and sufficient knowledge and authority to facilitate redemption. Second, the CFTC modified the "next-day redemption" requirement to expressly incorporate the SEC rule setting out exemptions, including in cases of non-routine market closings, emergencies preventing redemption, or a period ordered to protect investors; the CFTC also provided explicit safe harbor language that firms can use to ensure compliance.

The CFTC also made several other changes to the language used in Regulation 1.25 and the definition of the terms used therein. The term "readily marketable," previously used in defining permissible investments, was replaced with "highly liquid," which is defined as "having the ability to be converted into cash within one business day, without a material discount in value." Any reference to ratings requirements in the rules was removed, in accordance with the Dodd-Frank Act. In addition, the CFTC restricted any investment in certificates of deposits to only those instruments redeemable at the issuing bank within one business day and to certificates of deposits where the stated terms limit early withdrawal penalties to the accrued interest earned.

In announcing these amendments, the CFTC explained that it wanted to narrow the range of permissible investments to reduce the risk to customer funds, "consistent with the objectives of preserving principal and maintaining liquidity" under Regulation 1.25(b). Public officials have increasingly scrutinized the CFTC rules governing investment of customer funds. The CFTC first proposed the amendments more than a year ago, but efforts to approve these changes gained momentum after the recent MF Global bankruptcy.

The amended rule takes effect February 17, 2012; FCMs will then have until June 18, 2012 to comply.

European Developments

US$10 Million Fine Highlights the Extra-Territorial Reach of the European Market Abuse Regime

The UK Financial Services Authority ("FSA") fined a Dubai-based private investor (the "Investor") $9,621,240 (approximately £6 million) for manipulating the closing price of securities ("Securities") traded on the London Stock Exchange ("LSE"). The Securities were Global Depository Receipts ("GDRs") – financial instruments that are similar to American Depository Receipts. The issuer of the Securities had a primary listing of its shares in India but its GDRs were LSE traded. The Investor placed orders and executed trades that artificially inflated the closing price of the Securities. The timing of the orders was intended to ensure

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that market participants had insufficient time to respond before the closing price was determined. The Investor held an over-the-counter structured product from which the pay-out depended on the closing price of the Securities. By increasing the closing price, the Investor avoided a loss under the terms of the structured product and the counterparty bank to the structured product (the "Bank") overpaid him as a result of his manipulation of the Securities' closing price.

The FSA's action is significant both because it is the largest fine to date imposed by the FSA on an individual for market abuse and because the Investor carried on the acts giving rise to the fine outside the EU. This highlights the extra-territorial reach of the EU market abuse regime, with the place of the exchange on which the relevant financial instrument is trading, *i.e.*, a regulated market in any EU Member State, rather than the place of the alleged wrongdoer, determining liability. It also highlights the appetite that the FSA has for pursuing market abuse cases against those located outside the EU, let alone the UK. This is of particular relevance for investment managers or others who may regularly engage in transactions in securities or other financial instruments admitted to trading on an EU market.

Final Negotiations on Derivatives Clearing Proposal

On September 15, 2010 the European Commission ("Commission") published its proposal for a Europe-wide Market Infrastructure Regulation ("EMIR"). EMIR is similar in effect to the over-the-counter ("OTC") derivatives provisions in the Dodd-Frank Act and seeks to fulfill the EU's G20 commitment that all standardized OTC derivatives should be cleared through a central counterparty ("CCP"). It also requires OTC derivatives to be reported to a trade repository and imposes regulatory requirements on CCPs and trade repositories. Since the Commission's original proposal, the European Parliament and the European Council of Ministers ("Council") have each made various proposals for a final draft. On October 10, 2011, the Commission, EP and Council entered into trilogue negotiations to try to reach agreement on a compromise set of amendments. Significant points of difference include: (a) scope of the clearing obligation, particularly with respect to the exclusion of pension schemes and intragroup trades; (b) the corporate governance of CCPs, with the EP wanting significant representation of buy-side interests on CCP boards and committees; (c) third country provisions, with the Council seeking to introduce an international coordination requirement and extend the clearing obligation to trades between two non-EU parties; and (d) the segregation of client collateral held within a CCP with the EP wanting "full segregation" for clients to be the default choice for CCPs and the Council only wanting this to be optional. The parties are committed to reaching agreement on a final draft of EMIR by the end of the year.

Proposed Changes to the Markets in Financial Instruments Regime

The Markets in Financial Instruments Directive ("MiFID") established a Europe-wide framework for (a) the regulation of investment firms, such as investment managers and advisers, and (b) the operation of regulated markets such as stock exchanges. MiFID sets out provisions governing the authorization of and operating conditions for investment firms, including provisions on investor protection and market transparency and integrity and the rights of firm to provide services throughout the EU on the basis of a "MiFID Passport." Under its terms, MiFID was subject to a mandatory review and, following a consultation process during the course of 2010, on October 18, 2011 the European Commission ("Commission") published proposals for a recast Directive ("MiFID 2") and a regulation covering markets in financial instruments (MiFIR). The revisions are intended to address those MiFID provisions which have not met MiFID's original objectives and take into account the lessons learned from the recent financial crisis. As currently drafted, MiFID 2 and MiFIR would: (a) extend the current regime to include the activities of certain commodity firms; (b) impose regulatory requirements on firms undertaking algorithmic trading, including High Frequency Trading; (c)

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impose position limits on the trading of commodity derivatives; (d) introduce enhanced pre- and post-trade transparency provisions in respect of both equities and non-equities; (e) strengthen corporate governance standards within investment firms; and (f) impose restrictions on the provision of services in the EU by non-EU firms, whose home jurisdiction(s) would have to be seen as "equivalent" before those firms could provide services anywhere in the EU. This final set of restrictions is significant as it could adversely affect the extent to which non-EU entities in a fund management group interact with EU persons. The European Parliament, through its ECON Committee, and the Council will now review the proposals and put forward their own amendments ahead of the negotiations with the European Council over the final text which is expected to be agreed by the end of 2012. Once finalized, Member States will have two years to implement MiFID 2. MiFIR will take effect at the same time, i.e. in 2014.

Proposed Changes to the Market Abuse Regime

On October 18, 2011, the European Commission published legislative proposals for a new Market Abuse Directive (the "New Directive") and a new Market Abuse Regulation ("MAR") to replace the current Market Abuse Directive which underpins the laws on insider dealing and market manipulation throughout the European Union ("EU"). MAR will introduce a single directly applicable rulebook governing market conduct throughout the EU to be enforced via Member State administrative sanction. The New Directive will require all Member States to introduce criminal sanctions for intentional insider dealing and market manipulation. As the Council of Ministers and European Parliament will require time to negotiate and finalise the proposals, the timing of the implementation of the new Directive and MAR is uncertain although it is only likely to come into effect in 2014.

Please see Ropes & Gray Alert Expanding the Market Abuse Regime for European Securities and Investments - What Impact for Investment Managers? for a more complete description of this proposal.

Technical Guidance on the Implementation of the AIFMD Published

On November 16, 2011, the European Securities and Markets Authority ("ESMA") took the first legislative step towards the implementation of the Alternative Investment Fund Managers Directive ("AIFMD") by presenting its technical advice on the AIFMD implementing measures ("Technical Advice") to the European Commission (the "Commission"). The Technical Advice addresses issues that are relevant to non-EU managers, including co-operation agreements with "Third Countries," general provisions for managers, authorization and operating conditions, transparency requirements and leverage. The Commission is expected to finalize the implementation measures by the middle of 2012 to give Member States time to meet the deadline for implementation of the AIFMD through local law measures by July 21, 2013.

Agreement on a Uniform Short Selling Regime for Europe

On November 21, 2011, the European Parliament ("EP") and the Council of Ministers agreed a final text of the European Commission's proposed regulation to harmonize the restrictions and requirements on the short selling of shares and sovereign debt throughout the European Economic Area ("EEA"). (Whereas a directive, when finalized, must be implemented into each Member State's legislation, a regulation has direct and immediate effect.) The regulation: (a) introduces a ban on uncovered sovereign Credit Default Swaps but allows EEA Member State authorities to suspend the restriction in their own jurisdiction in specified circumstances; (b) imposes a requirement that, in order to be regarded as a covered short sale, the short seller must have (i) located the relevant shares and (ii) a reasonable expectation that settlement can be effected when due; (c) introduces an EEA-wide notification and reporting regime, whereby (i) holders of net short positions must notify these privately to the relevant Member State authority when they exceed 0.2% of the

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issued share capital of the issuer company and (ii) must publicly disclose these (on a named basis) when they exceed 0.5% (with each case requiring further notification or reporting at each 0.1% above the initial threshold); (d) provides Member State authorities and the European Securities and Markets Authority ("ESMA") with additional powers to intervene in the markets in times of stress; and (e) excludes sales under a repo agreement or futures contracts from the definition of short sales in shares and debt instruments. A period for secondary rulemaking now follows, with a consultation paper expected in January 2012 with the implementation deadline now scheduled for November 1, 2012.

Other Developments

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

Regulatory and Case Law Developments Relating to Hedge Fund Subscription Materials
December 19, 2011

Recent Enforcement Actions by SEC's Asset Management Unit Highlight New Proactive, Analytical Approach
December 14, 2011

Expanding the Market Abuse Regime for European Securities and Investments - What Impact for Investment Managers?
November 2, 2011

SEC Adopts Reporting Obligations for Advisers to Private Funds on New Form PF
November 1, 2011

Commodity Futures Trading Commission Announces Final Rule on Position Limits for Futures and Swaps
October 28, 2011

Proposed Volcker Rule and the Effect on Private Fund Sponsors and Investors
October 20, 2011

TIC Form SLT Reporting Requirements
September 9, 2011

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

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