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Investment Management Group

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The Challenges for Banks and Their Investment Funds Under the "Volcker Rule"

ROBERT M. HIRSH, ROBERT D. GOLDBAUM AND MICHAEL S. HONG

Introduction

On January 21, 2010, President Barack Obama - along with former Federal Reserve chairman, Paul Volcker - called for new restrictions on the size and scope of banks and other financial institutions to rein in excessive risk taking and to protect taxpayers. Often referred to as the "Volcker Rule," the proposed restrictions mandate that "no bank or financial institution that contains a bank own, invest in or sponsor a hedge fund or private equity fund."

On March 3, 2010, the White House released its draft of the proposed legislative amendments to the Bank Holding Company Act of 1956 that would put the Volcker Rule into effect. Among other provisions, the amendments define a "hedge fund" and a "private equity fund" as a company or other entity exempt from registration as an investment company under Sections 3(c)(1) or 3(c)(7) of the U.S. Investment Company Act of 1940 (the "Investment Company Act") - the most common regulatory exemptions utilized by sponsors in the private investment fund industry. Further, the amendments define "sponsoring" any such fund as: (i) serving as a general partner, managing member, or trustee of a fund; (ii) in any manner selecting or controlling (or having employees, officers or directors, or agents who constitute) a majority of the directors, trustees or management of a fund; or (iii) sharing with a fund, for corporate, marketing, promotional or other purposes, the same name or a variation of the same name. Related Volcker Rule-style proposals have taken the rule one step further, by barring the retention of any equity, partnership or other ownership interest, or investment, in a hedge fund or private equity fund.[1]

Critics have attacked the Volcker Rule and these proposed legislative amendments for focusing unnecessarily on a business arena that had little to do with the current financial crisis, the genesis of which, they argue, was excessive exposure to real estate credit risk. According to the private equity research firm Preqin, U.S. bank-sponsored funds raised a total of $80 billion in private equity capital commitments since 2006 - representing only 1% of the aggregate assets sitting on the balance sheets of Goldman Sachs, JPMorgan Chase, Citigroup, Morgan Stanley and Bank of America. Some commentators have also attacked the Volcker Rule for its intrusiveness, assuming that its adoption would require banks to divest themselves of hedge fund and private equity fund businesses in fire sales resulting in losses of value as banks are forced to sell divisions to buyers armed with significant tactical leverage. The prospect of such forced divestitures is all the more unappealing in an economic climate that is unlikely to support favorable valuations, and in light of the "fire sale" experience of many major financial institutions in 2008 after the implementation of FAS 157.

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[1] For summaries of other legislative efforts that mirror the tenets of the Volcker Rule, see herein "Proposed Legislation Affecting Private Funds."

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In his written testimony before the Senate Committee on Banking, Housing and Urban Affairs on February 2, 2010, Mr. Volcker argued that "hedge funds, private equity funds . . . unrelated to customer needs and continuing banking relationships should stand on their own." Based on such statements and the overarching requirement set forth in the proposed amendments that "appropriate Federal banking agencies shall jointly prohibit sponsoring or investment in hedge funds and private equity funds" by insured depository institutions, entities that control them or bank holding companies, the practical implications of the Volcker Rule, if enacted as law in its current form, are that banks that sponsor hedge fund or private equity fund businesses may need to sell them.

New Motivations for Old Transactions

Although acquisitions and divestitures of investment managers have become standard fare in the world of traditional money management, until recently, they were less common in the human-capital intensive and highly profitable, but volatile, world of alternative asset managers. From 2000 to early 2008, a number of high-profile sales of significant stakes in both hedge fund and private equity fund firms were completed, through private sales, quasi-public and public offerings, and combinations thereof. Prime examples of private sales of minority stakes include Morgan Stanley's acquisition of a minority stake in Avenue Capital Group in October of 2006, Lehman Brother's acquisition of a minority stake in the D.E. Shaw Group in March of 2007, Affiliated Managers Group's acquisition of minority stakes in Blue Mountain Capital Management and ValueAct Capital in the fourth quarter of 2007, and The Carlyle Group's sale of a 7.5% stake to the Mubadala Development Company, an affiliate of the Government of Abu Dhabi, in December of 2007.[2]

Additionally, there are examples of private minority sales that served as value-setting precursors to quasi-public and public offerings. Such sales include Fortress Investment Group's sale of a 15% stake to Nomura Holdings in December of 2006 (two months before listing its shares on the New York Stock Exchange (the "NYSE")), The Blackstone Group's sale of a 10% stake to the China Investment Company in May of 2007 (one month before listing its partnership units on the NYSE), Apollo Global Management's sale of a 20% stake to the Abu Dhabi Investment Authority and CalPERS in July of 2007 (one month before listing its units on the Goldman Sachs Rule 144A "GSTrUE" platform) and Och-Ziff's sale of a 10% stake to Dubai International in October of 2007 (one month before listing its shares on the NYSE). These examples and the others that accompanied them over the last decade marked a significant shift in the development of the once secretive private investment fund industry.

Prior to the financial crisis, seller motivations included personal diversification of founder wealth, employee incentivization, access to greater distribution and other strategic resources, and establishing a stronger acquisition currency. Buyers were often motivated by the search for diversification of their revenue base and access to additional asset management products. With the onset of the financial crisis, however, the sell-side motivations shifted dramatically. The motivations included changes, sometimes fundamental, in fund strategy, the need to dispose balance sheets of non-core or even "toxic" assets and, of course, the financial distress or bankruptcy of the fund sponsor itself. Unlike their predecessors, these transactions were less about liquidity or expansion than they were about exits.[3]

Banks or similar financial institutions that actively own, operate or sponsor hedge fund or private equity fund businesses, then, have a wide array of precedent transactions to turn to when trying to anticipate what strategic, commercial and legal issues a sale or other divestiture of those businesses might involve. The principal question that looms, however, is what challenges are likely to be most prevalent when those sales or other divestitures are motivated - indeed, compelled - by law. It is unlikely that such challenges will be different from those that beset transactions that occurred at the height of the financial crisis, but three challenges are likely to require the most attention.

The first challenge is determining the desired structure of the divestiture itself - what exactly is going to be sold, to whom and how? The second challenge is determining how to address the needs and concerns of the existing third-party investor base - what concerns will they have, and, ultimately, what obstacles will they, or could they, pose? The third challenge is determining the needs and concerns of the investment professionals that represent the core asset housed within the alternative asset manager - how does one retain them, or what role are they, or can they be, expected to play? We examine each of these challenges below.

Structural Challenges

To the extent that the proposed legislative amendments that attempt to codify the Volcker Rule seek to prohibit banks or their affiliates from "sponsoring" hedge funds or private equity funds - that is, from assuming a position of control over any such funds - then the path to an exit from these activities is likely to take one of the following three forms. The first form is a relatively straightforward sale of 100% of the bank's interest in the fund and its related alternative asset manager to an unaffiliated third party. Under this form, the buyer ends up owning 100% or a majority of the interests of the manager, and the investment professionals behind the fund's performance end up with employment contracts and/or economic incentives in the form of minority equity stakes in the manager, the buyer or one of their affiliates.

The second form of exit is the "sponsored" spin-off or spin-out - a transaction that results in the buyer acquiring a minority interest in the divested manager, with the investment professionals taking the majority. In this scenario, the buyer provides the necessary cash and liquidity to facilitate the transaction, but otherwise "invests" in the management team and plays a supporting role, perhaps in the capacity of a key investor, a service provider or some other source of strategic resources once offered by the existing sponsor. The third form is a variant of the second, but does not involve a third party financing source. Instead, the spin-off occurs to the investment professionals themselves, with the original sponsor retaining a minority interest going forward.

Given the choice, it is safe to assume that banks - forced to sell their *(continued on page 3)*

[2] Although less common than sales of minority stakes, sales of 100% stakes in alternative asset managers also occurred during the latter half of the last decade. Examples include Citi Alternative Investments' acquisition of 100% of Old Lane Partners, which was announced in April of 2007, and J.P. Morgan Asset Management's acquisition of Highbridge Capital Management in July of 2009.

[3] Interestingly, JPMorgan's spin-out of Bear Stearns Merchant Banking (now Irving Place Capital), following its acquisition of Bear Stearns in 2008, represents at least one example of an alternative asset manager divestiture driven by the need to manage a business conflict with an existing alternative asset management business (One Equity Partners) following a larger acquisition.

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hedge fund and private equity fund businesses - are likely to prefer the first and second options laid out above, rather than the third. Both options are more likely to maximize their cash return in the sale and are less likely to open a floodgate for other management teams seeking to acquire a majority of the businesses that they manage. Nevertheless, particularly in the context of a compelled sale, the reality is that bank sellers may have to settle for the third option if neither the first nor second are readily practicable. The only buffer against this risk are the versions of the Volcker Rule that seek to prohibit banks from retaining any equity, partnership or other ownership interest, or maintaining an investment in, a hedge fund or private equity fund. In other words, if banks are truly required to exit from the hedge fund or private equity fund businesses entirely, then retaining an interest itself may not be a viable alternative.

In any event, understanding the impact of the Volcker Rule is to recognize that its mandate will limit the transactional options that banks will have in any effort undertaken in the pursuit of compliance. Although those limitations may, in some instances, obviate certain options that may be less favorable overall, those limitations are also likely to force banks to contend - perhaps more directly - with the investor challenges and management challenges discussed further below.

Investor Challenges

Investors usually place their money in the hands of alternative asset managers based on the track record and performance history of the professionals that manage the assets and, often, the deal flow and other resources of the sponsoring firm. In the face of a sale that could result in a change of the managerial guard or in the separation of the team from its sponsoring institution, investors are likely to be concerned with the future identity, stability and reliability of the fund itself. In other words, with a change in the fund sponsor and potentially its management base, where will future business opportunities, deal flow and resources come from, and can the new sponsor or managers deliver on the promise of their predecessors?

Although a concerned client base is usually reason enough for a sponsor to understand the challenge investors might pose in the context of a compelled hedge or private equity fund sale, the crux of that challenge is more specifically a function of the legal leverage investors are often afforded in the language of the organizational documents (usually limited partnership agreements) that govern most funds or under the U.S. Investment Advisers Act of 1940 (the "Advisers Act"). More often than not, these organizational documents mandate investor approval or may require significant amendments in order to accommodate common sale transaction structures. For instance, a change of control of a general partner or investment advisor, a transfer of a general partner interest, a substitution of one general partner for another or the waiver of the contractual commitment of the incumbent general partner to fund capital along with other investors, may require, whether by express contractual provision or by operation of applicable law, some percentage of the investors to agree (or at least not object).

The effort to marshal that agreement, which is usually sought in the form of investor waivers or consents, can be complicated by key investors who enjoy the benefit of special arrangements, memorialized in the form of so-called "side letters," or fund structures that have investors sprinkled across multiple parallel funds or separately managed accounts, each of which contain their own unique negotiated arrangements and challenges. All of this assumes that the sponsor is able to determine from whom and under what circumstances such agreement is required under applicable law. The most common challenge is the deemed assignment provision of the Advisers Act - the provision that treats certain managerial changes of control as investment advisory agreement "assignments" for purposes of the Advisers Act requiring "client" consent. Divestitures also often raise difficult questions under Delaware limited partnership laws, many of which have yet to be tested in the courts. With this complex array of questions and potential pitfalls, it is no wonder that investors want, and usually feel that they can ask for, something in exchange for their agreement - whether it is an economic concession or otherwise.

In the hedge fund context, some investors, especially those with pressing liquidity needs of their own, may be willing to furnish a waiver or provide their consent in exchange for the ability to withdraw their capital, whether partially or completely, notwithstanding previously agreed-upon "lock-up" arrangements or suspensions of redemption rights that are in effect. Similarly, private equity fund investors might offer their waivers or consents in exchange for reductions in their unfunded commitments. The other economic concession sometimes sought by investors is a straight reduction in the management fees and incentive allocations - the so-called "carried interest" - that sponsors of such funds charge for their services. In any event, in the absence of an otherwise clear path to consummating a divestiture without investor support, banks faced with divesting themselves of hedge fund or private equity sponsorship are likely to have difficult economic negotiations ahead of them.

One route sponsors can take to manage and navigate through those challenges is seeking the views of the fund's advisory board - usually comprised of representatives of the fund's most significant investors. The advisory board is often consulted by a fund's general partner when the fund desires to take a course of action that deviates from what is permissible under the terms of the fund's organizational documents. New investment programs not originally contemplated, making investments that otherwise violate predetermined investment limitations and a whole host of other significant actions often require the approval, binding or otherwise, of the advisory board. However, apart from their potential contractual dimensions, the practical reality is that the advisory board represents yet another seat at the negotiating table. Furthermore, advisory boards generally do not show up at the table alone. In some recent sale transactions, they have retained counsel, engaged financial advisers and were generally prepared to make their voices heard, though they often avoided making a formal decision either way. The advisory board thus represents an important conduit through which incoming general partners and sponsors may be able to gauge what the investor base is likely to expect or requires in exchange for its blessing.

But getting the advisory board on board with a transaction sometimes only gets the transaction part of the way there. Sale transactions, especially those transacted under the type of duress one might expect when they are compelled by force of law in times of financial distress, are likely to elevate and provide a forum for underlying differences amongst the investors themselves. Large, cash-strapped institutional investors, for example, are more likely to seek economic concessions, such as withdrawal rights or reductions in unfunded commitments. Other investors, however, may prefer to protect the value of their investment portfolios, including those held through their hedge fund or private equity fund *(continued on page 4)*

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investments, in which case they are more likely to support the management team and sponsor going forward. The goals of institutional investors seeking liquidity and those investors seeking to protect their portfolios can be diametrically opposed. Of course, even investors seeking to protect their portfolios may be keen to benefit from fee and other concessions negotiated by the more distressed investors - getting opportunistic benefits in the process.

Then there are a host of other investor types in between whose unique needs and interests could serve to complicate or otherwise prevent any divestiture from resulting in what might otherwise be a "clean" break. For example, though they are generally less significant by dollar size, disgruntled retail investors can attempt to rebalance their relative importance through the threat or commencement of litigation against outgoing sponsors, even where the management team in question will continue to manage the fund post-closing. Recent lawsuits have charged, for example, that a sale, even if permissible under the letter of the fund's organizational documents, represents a fundamental alteration to the security that was marketed to the investor at the time the fund was formed. Another distinct investor group can include employee security funds - vehicles capitalized with sponsor-employee money from hundreds or even thousands of sponsor employees that invest in parallel with other sponsored funds but that are generally prohibited from being shifted as part of a sale transaction. These funds receive specific U.S. Securities and Exchange Commission ("SEC") orders enabling them to be exempt from the registration requirements of the Investment Company Act. Thus, a sale transaction that purports to sever its ownership from the bank sponsor whose employees' money was used to fund the security fund when it was established in the first place is simply a non-starter. Employee security funds are invariably left behind, but enter into sub-advisory arrangements with the incoming adviser.

Management Challenges

Apart from the government, investors are the most important external constituency that a bank or similar financial institutional will likely face in the context of a compelled hedge fund or private equity fund sale transaction. The most important internal constituency, however, are the investment professionals who are actually behind the fund's performance. It is for this reason that a sale or other divestiture of one type or another, compelled by law or otherwise, is typically only feasible if key elements of the management team remain in place and support the transaction. That is, since the value of the business itself is inextricably linked to the people that operate it, a divestiture of an alternative asset manager that does not include those people is likely to be highly value-destructive (if achievable at all).

For this reason, the investment professionals themselves can take on a number of roles in these transactions - whether as the prospective buyer or as yet another constituency whose professional, as well as economic, "happiness" is among the primary considerations both former and future sponsors must address to get the transaction to the finish line. Divestitures create periods of significant uncertainty and instability, and a group of managers concerned about their futures might be well positioned (or well advised) to seek opportunities elsewhere. In grappling with the ever present retention issue, tough questions will abound. What will be the role of management going forward from a decision-making and culture perspective? What tools will be used to encourage management to stay? Will management be offered an equity interest, presumably subject to retention tools such as vesting and forfeiture? How will that equity interest compare, if at all, to their existing compensation and economic incentives? How will the separation of outgoing management be handled *vis-à-vis* their prior fund sponsors? How does one address the needs of the employees or other professionals of the sponsor whose knowledge is critical to facilitating the sale, but whose future in the business following the sale is less clear? The views of management on these issues can be critical, as a lack of perceived strategic or cultural fit can stop a transaction before it starts. The multiple variations of these questions are often at the heart of what makes all sale transactions, let alone those compelled by law, so challenging.

Attention must also be paid to the potential for inter-managerial conflicts. Hedge fund and private equity fund management groups are rarely homogeneous. There can be generational issues between individuals or groups within management assigned to different asset classes, investment strategies and geographic locations. Such differences can result in sale transactions that produce not one, but perhaps multiple resulting operations, with disparate management teams each going their different ways and each representing a management constituency whose needs may need to be addressed in the context of all of the other transactions. Each group may hold a valid claim to the existing fund's track record and historical performance, or at least a piece of it, and tough negotiations are likely to result as different management groups fight for their right to use or claim ownership of that important marketing device. Like the opportunistic buyer who uses the leverage of a compelled sale to its advantage when negotiating the terms of the transaction, disparate or conflicting groups within management may well seek to do likewise.

Conclusion

The foregoing description of the challenges likely to be faced by financial institutions sponsoring alternative asset managers in a post-Volcker Rule world is an attempt to inform the reader of the most significant commercial and legal issues that are most likely to be encountered. This description, however, is not intended to be exhaustive. Other challenges that will undoubtedly characterize these transactions include valuation challenges. How does one value the stable management fees versus the relatively volatile performance or incentive fees fund sponsors and advisers earn in the context of a compelled sale? How should the incentive fees be valued when there is uncertainty as to the underlying portfolio? Then, there are structural issues - not all hedge fund or private equity fund transactions must be consummated through a sale or transfer of the ownership stakes in the general partner or adviser. They may, for instance, be accomplished through asset sales or some other combination of transaction steps. With such variations, it is difficult to draw general conclusions of what can be expected or anticipated, and it is important to seek experienced advisers at an early stage.

Nevertheless, if there is anything that can be said with certainty, it is that engaging in a divestiture compelled by law will likely amplify the issues that sellers of alternative asset managers have faced throughout the last decade in the context of similar transactions. Accordingly, participants in these transactions are more likely to achieve the most favorable result for their stakeholders by arming themselves with the knowledge of the suite of options, tools and other methods employed in the past to address similar transactions completed under a wide range of circumstances. Such participants would also be well served by maintaining their vigilance in the face of the challenges described above - challenges that will have a fundamental impact on their ability to maximize value in the face of an ever-changing regulatory landscape. ■

Are Your Insider Trading Policies Adequate?

RAPHAEL M. RUSSO AND JENNIFER A. SPIEGEL

Recent SEC enforcement activity and public statements by enforcement officials have refocused the private fund community on the tension between using all legitimate means to ferret out unique investment opportunities and stepping over the line into insider trading territory. Many fund sponsors are asking whether their current insider trading policies are adequate and what they can do to better protect themselves and their investment professionals from liability.

The Elements of Insider Trading

"Insider trading" is a serious offense with potentially severe penalties. Federal securities laws and regulations do not explicitly define "insider trading." However, the general anti-fraud provisions of Section 10(b) of the U.S. Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 (as promulgated by the SEC) have been interpreted by the federal courts to prohibit purchasing or selling securities, either in the open market or in private transactions, while in possession of material non-public information in violation of a duty.[1] If an insider cannot (or chooses not to) disclose material information, he or she must abstain from buying or selling.

In addition to prohibiting insiders from trading directly on inside information, Rule 10b-5 generally prohibits insiders ("tippers") from giving tips to family members or third parties ("tippees") - either by revealing non-public information to assist outside trading activities or by making buy or sell recommendations with an expectation of profiting, directly or indirectly, from such disclosure. Tippees who trade based on such inside information may also be subject to insider trading liability.[2]

Insiders and Tippees. Insiders typically include directors, officers, employees and significant shareholders of an issuer. Investment professionals may thus become "insiders" through an investment stake and/or a board position taken in respect of an issuer. In addition, they may have occasion to interact with a wide variety of individuals who have access to, or are themselves, insiders, including corporate officers, directors, industry experts and other active traders. As such, there are many contexts in which fund managers would find themselves in contact with persons who have material non-public information.

Material Non-Public Information. In the fast moving world of frequent trading that is typical of many hedge funds, assessing whether a trade is based on material non-public information ("MNPI") may not always be obvious.

- **Material Information.** Material information includes any information to which an investor would reasonably attach importance in reaching a decision to buy, sell or hold securities of an issuer. Significant developments concerning the issuer's business and operations, including its financial condition and results (particularly if the results represent a new trend or marked change from what the investing public might expect based upon past performance), upcoming earnings announcements and information with regard to proposed acquisitions or mergers are examples of information that is likely to be regarded as material. Ultimately, determining whether a particular piece of information is material depends heavily on the circumstances involved.

- **Public and Non-Public Statements.** In addition to filing the periodic reports required under the Exchange Act, an issuer may disclose current information in a variety of ways, including public announcements, press releases, interviews with media representatives and discussion with groups whose members have a particular interest in the issuer. Information is deemed to be "public" only after it has been widely disseminated to the marketplace through one or a combination of the methods mentioned above. Public information includes all issuer statements that can reasonably be expected to reach investors and the trading markets, without regard to the intended primary audience. Any communication outside these recognized channels of communication may be assumed to be non-public.

Considerations for Designing Insider Trading Policies and Procedures

In addition to ensuring that legitimate trading activity is properly documented and thus less vulnerable to challenge later on, fund sponsors must do what they can to prevent inappropriate or insider trading. Registered and unregistered advisers may face liability for failure to prevent insider trading. Many policies correctly and clearly set forth the standard of liability for insider trading, but few offer practical help to investment professionals in translating these standards into practical terms that can be implemented on a day-to-day real-time basis.

Explaining Materiality. A good policy should educate the firm's investment professionals about the concept of "materiality" and provide a real-time consultation resource for a trader or other investment professional who is assessing the materiality of information received. When a trader consults with a firm's chief compliance officer and relays the relevant facts to the officer, the fact that the trader consulted with the officer may help demonstrate good faith and refute any accusation of fraudulent intent.

Preventing Spread of MNPI. A good policy should not only prohibit trading on MNPI but also prohibit the spread of MNPI and anyone else's trading thereon, whether intentionally or accidentally. This means that policies and procedures should explain how one ensures that MNPI is kept confidential and that others are prohibited from trading on such confidential MNPI. Prohibiting the spread of MNPI involves developing procedures around the handling of MNPI in the physical sense - making sure such information is secure in protected files - and by limiting communications by those who possess MNPI with persons outside the firm.

The development of chat rooms (increasingly used by investment professionals to discuss investment ideas), blogs, Twitter, and PIN-to-PIN communication has added a new challenge to ensuring the confidentiality, and controlling the spread, of MNPI. The potential for multiple email aliases and the inability to track and record participation in some Internet venues can exacerbate the compliance challenge. Although registered advisers are already obligated to keep records of email communications and typically have the infrastructure to store such information, unregistered advisers may not have such infrastructure, and thus may not have the same means of monitoring investment professionals' communications. In addition, participation in chat rooms and the use of personal email cannot be tracked by a firm and should be prohibited.

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[1] 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.
[2] See 17 C.F.R. § 240.10b-5.

Are Your Insider Trading Policies Adequate? *(continued from page 5)*

Limitations of Taking Board Seats. If a firm's strategy permits or encourages the firm's taking board seats on any company, the policies should contemplate a clear mechanism whereby trading in that issuer will be limited and monitored.

Issues Associated with Public/Private Investing. Investing in both public and private securities of the same issuer (*e.g.,* publicly traded equity and privately traded debt) can raise complex information sharing issues. If a firm's strategy permits private and public investments in the same issuer, the policies should address the conflicts inherent therein, how the conflicts will be addressed, including either by implementing information barriers (which may not be practical given how investment decision-making is made at the firm), or determining upfront that the firm does not wish to receive MNPI (and having the issuer covenant not to provide any MNPI).

Update and Educate. New case law can affect best practices and general counsel and compliance officers need to not only update their policies to reflect these changes but educate their investment professionals of these changes and have them certify they have read any updated versions of a firm's insider trading policies.

10b5-1 Defenses. Rule 10b5-1 under the Exchange Act provides a means of establishing an affirmative defense that a purchase or sale of a security took place without the possession of inside information.[3] This may be helpful for investment professionals that routinely have access to MNPI but who may legitimately trade prior to receipt of such information. To establish such a defense, the person making the purchase or sale must demonstrate that before becoming aware of MNPI, the person had already either (i) entered into a binding contract with respect to such purchase or sale; (ii) instructed another person with respect to such purchase or sale; or (iii) adopted a written plan with respect to the purchase or sale of the issuer's securities. Having such contracts in writing and irrevocable and ensuring the contract is entered into in a timely manner can strengthen a 10b5-1 defense.

Expert Networks and Consultants. Many hedge funds rely on expert networks and individual consultants to make industry diligence more cost and time efficient. In its ideal form, an expert network will give a hedge fund access to individuals with industry expertise and insights without exposing the fund or any individual to any MNPI.

Well-established expert networks will take measures to reduce the risk that its experts provide MNPI, including one or more of the following: (i) requiring experts to covenant not to share any MNPI; (ii) requiring experts to represent that their participation in the network does not violate any contractual arrangements (including employment and confidentiality agreements) to which the expert may be subject; (iii) prohibiting connections between experts associated with a particular issuer and a hedge fund contemplating an investment in such issuer (the efficacy of which is predicated on a hedge fund's willingness to either disclose a target or refuse communication (on a no-names basis) with an individual associated with the target); (iv) limiting the scope of conversations with experts to general industry trends and other non-issuer specific industry questions; (v) prohibiting experts from discussing with a hedge fund manager any issuer that may be on that manager's restricted list; and (vi) prohibiting an expert from discussing an issuer that employs the expert. Before relying on any expert network, a fund manager should examine precautions being taken to prevent MNPI-sharing via network participation. Measures such as those outlined above should be carefully considered and provided for in any retention arrangements with an expert or consultant. The general counsel or outside counsel should be involved in the documentation being signed with, and any disclosures made to, any expert network or consultant retained by the firm.

However, the fact that a fund manager relies on an expert network to implement these measures in no way insulates a firm from charges of insider trading to the extent an individual receives MNPI and trades thereon. There is no "expert network" defense, and the risk of insider trading charges remains. Fund managers are well-advised not to assume that expert networks enforce or follow through on the precautions outlined above and should consider confirming compliance with each expert contacted.

Conclusion

Even the best designed compliance procedures cannot preclude outright fraud. However, a well-designed compliance policy should be able to better protect funds and their principals against the possibility that their employees or third parties will expose them and their firm to liability. The issues outlined above are complex. Determinations are very dependent on the particular circumstances of each situation, and the enforcement landscape is changing rapidly. Fund managers should encourage their investment professionals to seek guidance whenever they are unsure of how to handle potential MNPI and should seek advice from outside counsel as needed. ■

[3] 17 C.F.R. § 240.10b5-1.

New Requirements for Powers of Attorney Signed in New York by Individual Investors; Amendments to Law Already Proposed

Funds should note that changes that went into effect on September 1, 2009 to the New York General Obligations Law (ìNYGOLî) require powers of attorney that are executed by individuals in the State of New York to comply with certain requirements in order to be effective. As currently drafted, the statutory requirements inadvertently apply to powers of attorney that are commonly used in a wide range of commercial transactions, including fund agreements and subscription agreements, even though they do not appear to have any relevance to these types of transactions. On March 19, 2010, a bill was introduced in the New York State Assembly that would, among other things, exempt powers granted in these transactions from having to comply with the new requirements. However, until the legislative fixes are adopted, funds that accept subscriptions of fund interests from individual investors (i.e., natural persons) should consider drafting a separate power of attorney to be granted by such investors that contains the powers of attorney typically found in the subscription and fund agreements, and that complies with the changes to the NYGOL. The key requirements are that the power of attorney must contain, in size 12 point font, statutorily mandated cautionary language for the principal and the agent, and that the signatures of both the principal and the agent must be notarized (note that until the power of attorney is accepted by the agent through its signature of the same and the notarization of its signature, it is not effective). In addition, because the NYGOL provides for a presumption that a later granted power of attorney revokes all prior granted powers of attorney, it would be prudent to include provisions to the effect that the power of attorney does not revoke any prior granted attorney and that the newly granted power of attorney will not be automatically revoked by a later granted power unless the latter specifically references the former. ■

Update: Pay-to-Play Regulations

MICHAEL E. GERTZMAN, MARCO V. MASOTTI AND ERIC ALAN STONE

In the past year, investment managers have come under increasing scrutiny for "pay-to-play" practices. Public investigations of egregious alleged conduct have caused private self-examination and changed behavior. State legislatures and Attorneys General across the country have proposed codes of conduct. Public pension funds have adopted their own, plan-specific regulations and rules to guide and restrict the managers who seek to advise them. Additionally, in July of 2009, the SEC proposed new rules seeking to impose significant restrictions on investment managers to curb pay-to-play practices.

We have already reported on these investigations, regulations and proposed regulations in our Summer 2009 issue of Investment Fund News and in our August 11, 2009 client alert entitled *"SEC Proposes 'Pay-to-Play' Rule Regarding Political Contributions by Certain Investment Advisers."* Both remain available on our Firm's website, and provide useful background.

It is now time to provide an update about subsequent developments since then, and to offer some thoughts about what investment managers should be doing now to protect themselves in this environment. As we describe below, state Attorneys General have continued to prosecute pay-to-play violations, as has the SEC. State and local laws and pension plan rules have only expanded. While the SEC has not yet enacted its pay-to-play regulations, the Commission continues to accept comments and to meet with concerned parties as recently as the first week of February 2010. While many of the comments have urged the SEC to relax some proposed provisions, and while industry scuttlebutt suggests that the rules may change somewhat, it seems likely that some form of the rules will be enacted.

Recent Pay-to-Play Prosecution and Investigations

In our Summer 2009 issue, we reported on the much-publicized indictment against Henry "Hank" Morris, a chief political aide and fundraiser for former New York State Comptroller Alan Hevesi. The Morris prosecution has been the most visible pay-to-play prosecution. Although no investment manager was charged, New York Attorney General Andrew Cuomo announced that his Office had issued subpoenas to more than 100 managers that conducted business with New York public pension plans.

Attorney General Cuomo's investigation has led to guilty pleas, including from former Chair of the Liberal Party, Raymond Harding; founding partner of Aldus Equity, Saul Meyer; Chairman of Markstone Capital Group LLC, Elliott Brody; and most recently former chief investment officer of the New York state comptroller's office, David Loglisci. All pled guilty to felony charges. Markstone Capital itself agreed to return $18 million to the New York State Common Retirement Fund.

The SEC has publicly announced its intention to prosecute pay-to-play violations, and has begun to do so. The SEC joined in charging Hank Morris. Director of the Division of Enforcement Robert Khuzami cited the Hank Morris case and another SEC pay-to-play prosecution in his December 9, 2009 testimony before the United States Senate Committee on the Judiciary regarding the "Financial Meltdown."[1] SEC Chairman Mary Schapiro cited the Commission's pay-to-play prosecutions in the prepared remarks for her February 5, 2010 speech, "Looking Ahead and Moving Forward," at the annual Practicing Law Institute "SEC Speaks" conference in Washington, D.C.[2]

State Laws and Codes of Conduct

New York Attorney General Cuomo's much-publicized Public Pension Plan Reform Code of Conduct (the "New York Code") remains a prominent feature of the pay-to-play regulatory landscape.[3] It has been adopted by the New York State Teachers' Retirement System. As of March 2010 - eleven investment managers have signed on to the New York Code, including the Carlyle Group, Riverstone Holdings LLC, Pacific Corporate Group Holdings, LLC, HM Capital Partners I, Levine Leichtman Capital Partners, Access Capital Partners, Falconhead Capital, Markstone Capital (whose Chairman's guilty plea we noted above), Wetherly Capital LLC and, most recently, Ares Management LLC and Freeman Spogli & Co.

The New York Code:

- bans fund managers from using placement agents or lobbyists to establish a relationship or gain access to a public pension plan;
- prohibits fund managers from continuing with an existing investment by a public pension plan if the fund manager, its executives or their immediate family make a political contribution to an official of that pension plan, unless such fund manager, its executives or their immediate family are entitled to vote at the time of contribution and the contribution does not exceed $300 in the aggregate per election;
- requires fund managers to disclose actual and apparent conflicts of interest to the public pension plan (and, in some circumstances, to the New York Attorney General or other law enforcement officer), including information regarding company contributions and payments to placement agents; and
- increases the fiduciary standard of care governing the fund manager's interaction with the public pension plan, including a two-year ban in some circumstances on hiring former plan officials.

Since last summer, pay-to-play regulations - often modeled on the New York Code - have been debated in state and local legislatures across the country. The difficulties of balancing competing incentives here are recapitulated in the different outcomes that these legislatures have reached. Everyone wants to ban bribery and corruption, but everyone also wants public pension plans, even their small, local plan, to have access to the best investment managers around.

This played out in microcosm in New Jersey. Governor Chris Christie extended pay-to-play laws to labor unions on his first day in office. However, municipalities within Morris County alone split over how to address pay-to-play practices, with the Parsippany council adopting a pay-to-play ban and the Morris Township committee rejecting one. County seat Morristown faces the dilemma in real terms: a Newark firm that had been performing municipal bond work for the town for years made a $500 campaign contribution to the successful mayoral candidate. Must that longtime adviser now *(continued on page 8)*

[1] Testimony Concerning Mortgage Fraud, Securities Fraud, and the Financial Meltdown: Prosecuting Those Responsible. See http://www.sec.gov/news/testimony/2009/ts120909rk.htm

[2] Speech by SEC Chairman: "Looking Ahead and Moving Forward." See http://www.sec.gov/news/speech/2010/spch020510mls.htm.

[3] See http://www.ag.ny.gov/media_center/2009/sep/sep17a_09.html

Update: Pay-to-Play Regulations *(continued from page 7)*

be banned from working for the town?

These are the everyday issues that may be lost amid the zeal to punish obvious wrongdoers. For the most part, states are moving toward increased regulation, not away from it. Some recent examples include:

- In October 2009, Governor Arnold Schwarzenegger signed a California law that will require California public pension plans and retirement systems to develop and implement, before June 30, 2010, a policy requiring the disclosure of payments to placement agents, and imposing a five-year ban on new investments for any investment manager or placement agent that violates the disclosure policy.[4]
- In September 2009, Pennsylvania's Municipal Pension Plan Funding Standard and Recovery Act was amended to adopt a code of conduct requiring limited disclosure of the use of third parties, including placement agents and lobbyists, to communicate with municipal pension systems or their employees, and imposing a two-year ban on new investments or accepting carried interest on a previous investment after an affiliate of an investment manager makes a political contribution to a municipal office or candidate for municipal office.[5]
- In September 2009, New York State Comptroller Thomas DiNapoli signed an executive order prohibiting the New York State Common Retirement Fund from doing business for two years with any investment adviser who has made a political contribution to the comptroller or a candidate for the Comptroller's Office.[6]
- In September 2009, the board of the Arizona Public Safety Personnel Retirement System discussed policies regarding placement agent fees, and that discussion appears to be ongoing.[7]
- In December 2009, the board of the Los Angeles City Employees Retirement System adopted principles requiring disclosure of political contributions to trustees or elected officials by placement agents or investment managers.[8]
- In February 2010, New York City Comptroller John C. Liu imposed regulations limiting campaign contributions and prohibiting gifts to employees of the Comptroller's Office and New York City pension systems, and limiting the use of placement agents in connection with those pension systems.[9]

The SEC's Proposed Pay-to-Play Rules

The SEC also appears to be preparing to regulate pay-to-play practices. Last Summer, we described the SEC's proposed regulations, entitled "Political Contributions by Certain Investment Advisers," under Rule 206(4)-5 of the Advisers Act.[10]

The SEC's proposed rule has three principal components:

- **Ban on Use of Placement Agents.** The SEC would prohibit fund managers from paying third parties to solicit government entities for investment business.
- **Two-Year Restriction on Compensation.** The SEC would prohibit fund managers from receiving compensation for providing advisory services to a government entity for two years after the fund manager (or certain persons employed by or associated with it) makes a political contribution to a public official or candidate for state, local or municipal public office who is in a position to influence the award of advisory business. The compensation ban, if triggered, applies not only to new investments, but to receiving compensation (including carried interest) on investments that preceded the political contribution. The ban also applies to contributions made by new employees before they were hired by the investment manager. There are exceptions for contributions of $250 or less, per employee per election, to candidates for whom the employee is permitted to vote, and for contributions of $250 or less, in the aggregate, per election, that otherwise violate the rule but that the investment manager returns within certain time limits. The proposed rule also provides limited circumstances in which an investment adviser may apply for an exemption from the two-year ban. Notably, the proposed rule has no scienter requirement: the ban is automatically triggered by a covered political contribution, even if the employee making the contribution has no intent to influence investment decisions.
- **Ban on Bundling and Soliciting Contributions.** The SEC would prohibit fund managers and certain executives and employees from soliciting or coordinating political contributions to officials or candidates for office where the fund manager is seeking to provide investment services.

The SEC's comment period for the new proposed rule began in July of 2009, and was supposed to end in October of 2009. Comments, however, have continued to be submitted, including most recently a comment on February 2, 2010 by Senator Christopher J. Dodd. Many of the comments have been favorable. Nearly all are at least partly favorable, as many commentators with criticisms of aspects of the proposed rule nevertheless applaud the desire to curb the most extreme pay-to-play practices.

Many of the comments have centered on - and are critical of - the proposed ban on the use of placement agents. While most commentators favor increased disclosure of the use of placement agents, many oppose banning their use outright. Pension plans themselves have championed the role of placement agents in providing needed access to fund managers for smaller, or more isolated plans. Financial institutions have made the same observation. Senator Dodd wrote to "share the concern that a ban on placement agents could reduce the amount of information available to public funds about the full range of investment opportunities."

Other commentators have expressed concerns about the effect that an immediate, two-year ban will have on existing plan-adviser relationships. The National Conference of State Legislatures, the National Association of Counties, the National League of Cities and other similar *(continued on page 9)*

[4] See Assembly Bill No. 1584 (October 11, 2009), http://leginfo.ca.gov/pub/09-10/bill/asm/ab_1551-1600/ab_1584_bill_20091011_chaptered.pdf.

[5] See Act 2009-44 (September 18, 2009), House Bill 1728, Printer's No. 2638, 53 P.S. §§ 895.101 et seq.

[6] See http://www.osc.state.ny.us/reform/politicalcontribution.pdf.

[7] See http://www.psprs.com/Admin_common/FundManager/Fund_Manager_Meetings/Minutes/2010/PSPRS%20-Fund%20Manager%20Sept%2023,%202009.pdf.

[8] See http://www.lacers.org/AboutLACERS/Board/BoardDocs/2009/2009%20Investment%20Committee/20090428/ITEM%20III%20%20CONSIDERATION%20OF%20THIRD%-20PARTY%20MARKETING%20AND%20REFERRALS%20DISCLOSURE%20POLICY.pdf

[9] See http://comptroller.nyc.gov/press/2010_releases/pr10-02-021.shtm

[10] See 74 Fed. Reg. 3840 (Aug. 7, 2009).

Update: Pay-to-Play Regulations *(continued from page 8)*

organizations wrote to suggest that an "abrupt termination of . . . long standing investment adviser relationships . . . would likely take place as a result of the implementation of the two-year time-out as currently set forth in the proposed rule," and that the SEC "did not give adequate consideration to how the termination of these relationships would affect state and local plans and governments." Members of these organizations expressed concern "that the abrupt termination of the fund or government's long-standing investment professional that might result in order to comply with the proposed rule could undermine the fiduciary duty or authority of the plan's Board of Trustees."

Still other commentators have expressed concerns about the rights of investment advisers. One commentator asked whether an automatic two-year ban subverts due process by punishing the investment adviser without first providing notice and an opportunity to be heard. Another asked whether, in light of the U.S. Supreme Court's recent decision in the *Citizens United* case,[11] a ban on political contributions by investment advisers might violate the First Amendment.

Thus far, the SEC has not implemented the proposed rule or changed its text. It is clear, however, that the SEC's work continues. SEC staff met with representatives of the Investment Adviser Association, Legg Mason, and T. Rowe Price on January 13, 2010 to discuss the issue, and Chairman Mary Schapiro, Commissioner Elisse Walter and SEC staff met with representatives of the Ohio Public Employees' Retirement System on February 4, 2010.

What Should a Fund Manager Do Now?

With the SEC continuing to consider a new pay-to-play rule, and codes of conduct and legislation being debated and implemented across the country, what is an investment adviser to do?

There is no one right answer, particularly not with the SEC rule pending but not implemented. Each investment adviser is differently situated, and thus there will never be a one-size-fits-all approach; however, we can offer some general thoughts, which investment advisers may wish to discuss with their own counsel:

- **Stay aware.** New regulations are being debated and passed, and many of them apply immediately to pre-existing investments.
- **Assess your investments.** How much of the money that you manage came from public pension and retirement plans or from other government entities? When were those investments made? Can you demonstrate how much you received, from whom, and how long ago, to ensure that you can calculate and demonstrate the effect of any ban on compensation?
- **Assess your use of placement agents.** Do you need them? What disclosure has already been made? Are you using placement agents to solicit business from any pension plans that do not know your identity, the placement agent's identity and any compensation arrangements with the agent and/or plan?
- **Assess your political contributions.** Do you have a policy limiting, prohibiting or permitting the political contributions by your employees and officers? Do you have record-keeping requirements for those contributions? Is your firm regularly solicited by others - clients, prospective clients, important colleagues - to participate in group or bundled political contributions? Do you solicit such contributions yourself?
- **Assess your hiring practices.** When you hire a new employee or officer, do you ask her to tell you what political contributions she has made in the past two years?

Some or all of these questions may prove important in the coming months. Some, but likely few, will turn out to have been irrelevant. With regulation looming, it is a good time for investment advisers to assess and perhaps address their own behavior before having to justify it elsewhere.

[11] *Citizens United* v. *Federal Election Commission,* 2010 WL 183856 (U.S.).

Welcome Philip Heimowitz

We are pleased to announce that Philip Heimowitz joined Paul, Weiss on January 25, 2010 as Counsel in the Investment Funds Group and the Securities Group. Phil received an LL.M. in taxation from New York University School of Law in 1986, a J.D. from Benjamin Cardozo School of Law in 1981, and a B.B.A from Bernard Baruch College in 1978. Most recently, Phil was Special Counsel in the Investment Management - Registered Funds Group at Schulte Roth & Zabel LLP.

Recent Litigation Affecting Private Funds

REDEMPTIONS

Aris Multi-Strategy Fund, L.P. et al. v. Accipiter Life Sciences Fund II (QP) et al.

On January 21, 2010, the New York State Supreme Court (the "Court") dismissed in its entirety a complaint brought against Accipiter Life Sciences Fund II (QP), L.P., Accipiter Life Sciences Fund II, L.P., Accipiter Life Sciences Fund II (Offshore), Ltd. (collectively, "Accipiter"), the general partner of the Accipiter onshore funds ("Candens"), the management company ("ACM") and one of its principals (the "ACM Principal") by two fund of funds investors ("Aris") whose redemption requests were denied following a determination by Accipiter to suspend redemptions. During the third quarter of 2008, approximately 60% of the investors in the Accipiter funds (excluding Aris) had submitted redemption requests as of September 30, 2008. In early October 2008, Aris submitted a redemption request in respect of its investments in the onshore Accipiter funds, effective as of December 31, 2008, and shortly thereafter made a similar request in respect of its investments in the offshore Accipiter fund. The fund documents provided for quarterly redemptions, to be effective as of the end of each calendar quarter. Shortly after Aris submitted its redemption requests, Accipiter advised investors that it would be liquidating its funds and that redemption requests received on or before September 30, 2008 would be honored; however, all requests received after such date would be subject to suspension. In response, counsel for Aris wrote to Accipiter asserting that "they must treat all investors equally and honor the plaintiffs' redemption requests." Shortly thereafter, Aris commenced its lawsuit against Accipiter, Candens, ACM and the ACM Principal asserting, among other things, breach of fiduciary duty, recklessness/gross negligence, breach of the organizational and offering documents of Accipiter's funds and negligence, and seeking declaratory and injunctive relief. In its complaint, Aris also alleged that Accipiter over-valued certain of its fundsí assets, failed to prepare prudently for redemptions, purchased large investment positions in September and October 2008 and employed leverage in excess of the permissible limits set forth in the governing documents of the funds. *(continued on page 10)*

Newly Enacted Laws Affecting Private Funds

Amendments to Rule 206(4)-2 Under the Advisers Act

On December 30, 2009, the SEC published a release adopting certain amendments to the custody and recordkeeping rules applicable to registered investment advisers under the Advisers Act and related forms (the "Release").[1] Newly amended Rule 206(4)-2 under the Advisers Act (the "Amended Rule") requires a registered investment adviser that has "custody" of client assets to, among other things: (i) undergo an annual surprise examination by an independent public accountant to verify client assets (*subject to certain enumerated exceptions, including an exception for an investment fund that provides annual audited financial statements as more fully described below);* (ii) have a reasonable basis after due inquiry, for believing that the "qualified custodian" maintaining client assets sends account statements directly to the advisory clients; and (iii) unless client assets are maintained by an independent custodian (*i.e.,* a custodian that is not the investment adviser itself or a related person of the investment adviser), obtain, or receive from its related person, an annual report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board (the "PCAOB").

The Amended Rule provides special rules for registered investment advisers to pooled investment vehicles such as limited partnerships, limited liability companies and other similar investment vehicles, including private investment funds. A summary of these rules follows.

Under the Amended Rule, an investment adviser shall be deemed to have complied with the annual surprise examination requirement with respect to an investment fund that is subject to an audit: (i) at least annually and distributes its audited financial statements, prepared in accordance with generally accepted accounting principles ("GAAP"), to all of the fund's investors within 120 days of the fund's fiscal year-end (or within 180 days for funds of funds); (ii) conducted by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB as of the commencement of the professional engagement period and as of each calendar year-end; and (iii) upon liquidation of the fund and distributes its audited financial statements, prepared in accordance with GAAP, to all of the fund's investors promptly after the completion of such audit (the "Annual Audit Provision"). In addition, under existing Rule 206(4)-2(a)(1), a registered investment adviser that has "custody" of client assets (with certain limited exceptions[2]) must maintain such client assets with a "qualified custodian" in either a separate account for each client under that client's name, or alternatively, in accounts that contain only the adviser's clients' funds and securities, under the adviser's name as agent or trustee for the clients. The Amended Rule establishes an additional requirement where an investment fund's assets are maintained with a qualified custodian that is either the investment adviser to the fund or a related person of the investment adviser. In these circumstances, the investment adviser must obtain, or receive from its related person, no less frequently than once each calendar year, a written, internal control report prepared by an independent public accountant. The accountant issuing the internal control report must be registered with, and subject to regular inspection as of the commencement of the engagement period, and as of each calendar year-end, by the PCAOB. The Amended Rule became effective March 12, 2010.

Please see our January 8, 2010 client alert entitled *"How Will the Recently Amended Investment Adviser Custody Rule Affect Investment Funds?"* for further information on this topic. *(continued on page 11)*

[1] http://www.sec.gov/rules/final/2009/ia-2968.pdf. On March 15, 2010, the SEC posted responses to certain frequently asked questions regarding the new custody rule. See http://www.sec.gov/divisions/investment/custody_faq_030510.htm.

[2] Importantly, an investment adviser is not required to maintain custody of client assets with a "qualified custodian" with respect to certain "privately offered securities;" provided, that such adviser complies with the annual audit requirement. In such circumstances, the investment adviser will not be subject to the internal control report requirement.

Recent Litigation Affecting Private Funds

(continued from page 9)

The Court first considered Aris' b reach of fiduciary duty, breach of contract and negligence claims against the Accipiter funds; and dismissed each cause of action. With respect to Aris' breach of fiduciary duty claim, the Court stated that the Delaware Revised Uniform Limited Partnership Act "did not create a fiduciary duty among constituent limited partners" (although the Court did not explain how the absence of a fiduciary duty in this context also resulted in its dismissal of Aris' breach of contract and negligence claims).

The Court next considered Aris' claims against Candens, ACM and the ACM Principal for breach of fiduciary duty - again, dismissing each cause of action in reliance on the exculpatory language contained in the governing documents of the funds, which expressly precluded liability of the parties in the absence of gross negligence or willful misconduct. The Court also noted that under the governing documents of the funds, Candens: (i) had ìsole discretionî to purchase and sell investments; (ii) was given express authority to suspend redemptions; and (iii) was required to process redemptions "on a first in, first out basis." In addressing Aris' claim of recklessness/gross negligence against these parties, the Court limited its analysis to Aris' allegations regarding the overvaluation of certain assets and the failure to liquidate such assets in a timely manner, which the Court recognized as patently insufficient to establish "an extreme departure from the ordinary standard of care."

In denying Arisí request for declaratory and injunctive relief, the Court recognized that the governing documents of the funds explicitly authorized Accipiter to suspend redemptions and that injunctive relief was not available in an action for money damages. The Court also dismissed Arisí claim for unjust enrichment, citing the existence of a contract governing the relationship between the parties giving rise to such claim as the reason for its failure, as well as Aris' claim for punitive damages, recognizing that without any specific allegation of conduct that was ìparticularly reprehensible,î the necessary pleading requirements were not satisfied. ■

Newly Enacted Laws Affecting Private Funds *(continued from page 10)*

Final Model Privacy Form Under the Gramm-Leach-Bliley Act

On November 16, 2009, eight federal regulatory agencies, including the SEC and the Federal Trade Commission, released a final rule that adopts an optional model privacy notice form that will make it easier for consumers to understand how financial institutions collect and share personal information about consumers.[3] Under the Gramm-Leach-Bliley Act (the "GLB Act"), financial institutions must notify consumers of their information-sharing practices and inform consumers of their right to opt out of certain sharing practices.[4] The final rule provides that a financial institution that chooses to use this model form obtains a legal "safe harbor" and will satisfy the disclosure requirements for notices. The GLB Act broadly defines "financial institution" to include private investment funds. As a result, such funds are required to provide an initial privacy notice, as well as annual privacy notices, to their investors that accurately reflect the funds' privacy policies and practices, unless an exception applies. Financial institutions are not required to adopt the model form; however, if a financial institution decides not to adopt the model form, it should review its current privacy notices to determine whether revisions are required in order to comply with the final rule. Please see our February 2, 2010 client alert entitled *"New Privacy Policy Rule May Require Private Funds to Modify Their Privacy Notices"* for further information on this topic.

Amendments to Reporting Requirements for Commodity Pool Operators

On November 9, 2009, the U.S. Commodity Futures Trading Commission ("CFTC") adopted amendments to its regulations regarding periodic and annual reporting requirements applicable to commodity pool operators ("CPOs") under Regulation 4.22.[5] The amendments became effective on December 9, 2009. Changes that affect annual reporting requirements will be applicable to commodity pool annual reports for fiscal years ending December 31, 2009 and later.

- **Non-unitized 4.7 Pools.** The amendments clarify that the periodic account statements for non-unitized pools operating under Rule 4.7 must disclose either the net asset value per outstanding participation unit in the pool or the total value of a participant's interest or share in the pool.
- **Multiple Series Pools.** The amendments specify detailed information that must be included in the periodic account statements and annual reports for commodity pools with more than one series or class of ownership interest. Pools with different series or classes may limit periodic reporting to the series or class being reported only if the pool has limited liability among the various series or classes. Pools with cross series or class liability must report the required information for both the pool as a whole and for each series or class of ownership.
- **Fund of Funds Annual Reports.** The amendments extend the time period for a CPO to file and distribute annual reports of commodity pools that invest in other funds to 180 days after the end of the pool's fiscal year. The amendments allow a CPO to claim an automatic extension of 90 days, rather than 60 days. The extension also includes CPOs that operate Rule 4.7 exempt funds of funds.
- **Profit Allocations.** The amendments codify existing CFTC interpretations of disclosure requirements for: (i) special allocations; (ii) combined gains and losses for regulated and non-regulated transactions; and (iii) investee fund expenses.
- **Liquidating Pools.** Liquidating Pools. The amendments streamline annual reporting requirements for pools ceasing operation. Generally, a CPO is required to provide a liquidating pool's final report to investors and the National Futures Association ("NFA") within 90 days of cessation of trading.
- **Offshore Pools.** The amendments codify exemptions the CFTC has provided to CPOs that operate offshore funds that elected not to use GAAP in the preparation of pool financial statements.
- **4.13 Funds.** The amendments delete the requirement that any annual reports provided by pools exempt under Regulation 4.13 must be presented and computed in accordance with GAAP and audited by a certified independent public accountant.

New York State Comptroller Bans Pension Fund Pay-to-Play

On September 23, 2009, New York State Comptroller Thomas P. DiNapoli banned pay-to-play practices related to the New York State Common Retirement Fund ("CRF") by issuing an executive order that prohibits CRF from doing business with any investment adviser who has made a political contribution to the State Comptroller or a candidate for State Comptroller.[6] The ban, which closely parallels proposed SEC regulations, will last for two years from the date of the political contribution.

California Passes Placement Agent Law

On October 13, 2009, California Governor Arnold Schwarzenegger passed Cal. Gov. Code §§ 7513.85 and 7513.9, which will require all California state and local pension funds to disclose any fees paid by managers to placement agents in connection with securing business from such pension fund. Managers that violate the disclosure requirements will be prohibited from seeking business from the pension fund for two years. The law also requires placement agents to disclose any campaign contributions made to pension fund board members in the 24 months prior to soliciting pension fund money. The law also extends to five years (from two years) the period of time that pension fund board members and employees have to wait before pitching business to the pension fund if they defect for the private sector. State and local pension funds have to adopt the enhanced disclosure requirements by June 2010. ■

[3] http://www.sec.gov/rules/final/2009/34-61003fr.pdf.

[4] 15 U.S.C. §§ 6801 et seq.

[5] http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/e9-26789a.pdf.

[6] See http://www.osc.state.ny.us/reform/politicalcontribution.pdf.

Proposed Legislation Affecting Private Funds

The "Volcker Rule"

On January 21, 2010, President Obama, joined by Paul Volcker and others, proposed new measures calling for new restrictions on the size and scope of banks and other financial institutions to rein in excessive risk taking and to protect taxpayers. On March 3rd, President Obama sent a draft of the legislation to Congress entitled "Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds." Among other things, the proposal would prohibit banks from "sponsoring" (defined as serving as the general partner, managing member or trustee of a fund; in any manner selecting or controlling a majority of the directors or management of a fund; or sharing with a fund, for corporate, marketing, promotional or other purposes, the same name or a variation of the same name) and investing in hedge funds and private equity funds (defined as any entity exempt from registration as an investment company pursuant to either Section 3(c)(1) or 3(c)(7) of the Investment Company Act). Banks also would be prohibited from acting as a prime broker to funds they advise.

On March 10th, Senators Jeff Merkley, Carl Levin, Ted Kaufman, Sherrod Brown and Jeanne Shaheen introduced their version of the "Volcker Rule" entitled the "Protect our Recovery Through Oversight of Proprietary Trading Act." The bill, among other things, would bar banks, bank holding companies, and their affiliates and subsidiaries from taking or retaining any equity, partnership or other ownership interest in or sponsoring a hedge fund or a private equity fund. The defined terms "hedge fund," "private equity fund" and "sponsoring" track the definitions set forth in President Obama's proposal.

On March 15th, Senate Banking Committee Chairman Christopher Dodd introduced his version of the "Volcker Rule" entitled "Restrictions on Capital Market Activity by Banks and Bank Holding Companies" as part of his financial overhaul bill. Senator Dodd's version would, among other things: (i) prohibit banks, bank holding companies, and their affiliates and subsidiaries from "sponsoring or investing in a hedge fund or a private equity fund;" (ii) bar banks, bank holding companies, and their affiliates and subsidiaries, or companies that serve as the investment manager or investment adviser to a hedge fund or private equity fund from entering into a "covered transaction" (as defined in section 23A of the Federal Reserve Act to include loan-making, purchase or investment in securities, purchase of assets, guarantee, *etc.*) with such hedge fund or private equity fund; and (iii) impose additional capital requirements and additional quantitative limits on nonbank financial companies supervised by the Federal Reserve pursuant to its oversight authority under the bill (see Financial Stability Oversight Council below) that engage in proprietary trading or sponsoring and investing in hedge funds and private equity funds. Again, the defined terms "hedge fund," "private equity fund" and "sponsoring" track the definitions set forth in President Obama's proposal.

Private Fund Investment Adviser Registration (House Version)

On December 11, 2009, the U.S. House of Representatives passed "The Wall Street Reform and Consumer Protection Act of 2009." The bill sets forth a comprehensive set of financial regulatory reforms, including the "Private Fund Investment Advisers Registration Act of 2009," which would eliminate the "private adviser exemption" from registration under Section 203(b)(3) of the Advisers Act, and, instead, require any investment adviser to a "private fund" to register with the SEC (subject to certain exemptions) and subject the private funds advised by such SEC-registered advisers to substantial regulatory reporting requirements. A "private fund" is defined as an issuer that would be an "investment company" under Section 3(a) of the Investment Company Act, but for the exception provided from that definition by either Section 3(c)(1) or Section 3(c)(7) of such Act.

Importantly, the bill provides the following exemptions (among others) from registration as an investment adviser with the SEC:

- any private fund adviser that "acts solely as an adviser to private funds and has AUM in the United States of less than $150 million" (such an adviser would still be subject to certain recordkeeping and annual reporting requirements described below);
- any adviser to "venture capital funds" (which is to be defined by the SEC) (such an adviser would still be subject to certain recordkeeping and annual reporting requirements described below);
- any adviser that is a "foreign private fund adviser" defined as an investment adviser that: (a) has no place of business in the United States; (b) during the preceding 12 months has had (i) in total, fewer than 15 clients and investors in the United States in private funds advised by such investment adviser; and (ii) aggregate AUM attributable to clients and investors in the United States in private funds advised by such investment adviser of less than $25 million; and (c) neither holds itself out generally to the public in the United States as an investment adviser, nor acts as an investment adviser to any investment company registered under the Investment Company Act; and
- any adviser to small business investment companies, which are regulated by the Small Business Administration.

Such SEC-registered advisers would be required to maintain such records of and file with the SEC such reports regarding the private funds that they advise as "are necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk as the SEC determines," including for each private fund: the amount of AUM; the use of leverage (including off-balance sheet exposures); counterparty credit risk exposures; trading and investment positions; and other important information relevant to determining potential systemic risk. All records of a private fund maintained by a SEC-registered adviser would be subject at any time to such periodic, special and other examinations by the SEC.

In addition, in prescribing regulations (including registration and examination procedures) relating to advisers of "mid-sized private funds," the SEC must take into account the size, governance and investment strategy of such funds to determine whether they pose systemic risk; however, the bill does not provide a definition of "mid-sized private funds."

The SEC would be permitted to share copies of all reports and documents filed with or provided to it by an SEC-registered adviser with the Board of Governors of the Federal Reserve System and to Oversight Council as necessary for the purposes of assessing the systemic risk of a private fund. In addition, a registered adviser must provide reports to investors, *(continued on page 13)*

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prospective investors, counterparties and creditors of any private fund advised by such adviser. The SEC may not compel a private fund to disclose certain proprietary information to counterparties and creditors, including sensitive, non-public information regarding the investment adviser's investment or trading strategies, analytical or research methodologies, trading data, computer hardware or software containing intellectual property.

The bill gives the SEC broad authority to issue, amend and rescind such rules and regulations as are necessary or appropriate to carry out the intent of the bill, including the ability to: (i) classify persons and matters within its jurisdiction based upon, but not limited to, size, scope, business model, compensation scheme or potential to create or increase systemic risk; (ii) prescribe different requirements for different classes of persons or matters; and (iii) ascribe different meanings to terms (including the term "client," except that the SEC cannot define the term "client" to include an investor in a private fund).

Please see our December 16, 2009 client alert entitled *"House Passes Bill Requiring Most Private Fund Investment Advisers to Register"* for further information on this topic.

Private Fund Investment Adviser Registration (Senate Version)

On March 15, 2010, Senate Banking Committee Chairman Christopher Dodd introduced a sweeping financial regulatory bill that included the "Private Fund Investment Advisers Registration Act of 2010." The Senate Banking Committee had released an earlier discussion draft in November 2009. On March 22nd, following Committee discussions of these drafts, the Senate Banking Committee adopted an amended version of Senator Dodd's bill, which is substantially similar to the House bill, with the following key differences:

- provides an exemption from registration (but not from certain recordkeeping and reporting requirements) for any adviser to a "private equity fund" (which is to be defined by the SEC);
- provides an exclusion from the definition of "investment adviser" under the Advisers Act for any "family office" (which is to be defined by the SEC in a manner consistent with the SEC's prior exemptive orders);
- does not contain a provision regarding regulation of "mid-sized private funds;"
- provides an aggregate AUM registration threshold of $100 million;
- requires disclosure to the SEC of any "side arrangements or side letters whereby certain investors in a fund obtain more favorable rights or entitlements than other investors;"
- requires an investment adviser to take steps as the SEC may prescribe to safeguard client assets over which it has custody, including verification of such assets by an independent public accountant;
- generally requires investment advisers to maintain the same types of records as noted in the description of the House bill above; however, there is no requirement to file such records with the SEC; the SEC may issue rules requiring each investment adviser to a private fund to file such reports containing such information as the SEC "deems necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk;" and
- does not contain third-party disclosure requirements.

Investor Protection; Broker Dealers (House Version)

Included in the passage by the House of the omnibus Wall Street Reform and Consumer Protection Act was the "Investor Protection Act of 2009." Of significance to investment advisers, the bill provides that, with respect to a broker or dealer, when providing personalized investment advice about securities to a retail customer, the standard of conduct for such broker or dealer will be the same standard as applicable to an investment adviser under the Advisers Act.

Investor Protection; Broker Dealers (Senate Version)

Senator Dodd's financial overhaul bill included a version of the "Investor Protection Act of 2009," which would require the SEC to conduct a study to evaluate (i) the effectiveness of existing legal or regulatory standards of care for broker dealers and investment advisers for providing personalized investment advice and recommendations about securities to retail customers; and (ii) whether there are legal or regulatory gaps or overlap in the legal or regulatory standards in the protection of retail customers relating to the standards of care for broker dealers and investment advisers.

Executive Compensation (House Version)

The omnibus Wall Street Reform and Consumer Protection Act also included the "Corporate and Financial Institution Compensation Fairness Act of 2009," which would, among other things, require certain "covered financial institutions" - including investment advisers and broker-dealers - with assets of at least $1 billion to disclose to the appropriate Federal regulator the structures of all incentive-based compensation arrangements. The disclosures must allow regulators to determine whether such structures are aligned with sound risk management and their potential to have serious adverse effects on economic conditions or financial stability. Federal regulators would have the authority to prescribe rules preventing incentive-based compensation arrangements that regulators determine pose "serious adverse effects on economic conditions or financial stability."

Executive Compensation (Senate Version)

Senator Dodd's financial overhaul bill contains a modified version of regulatory requirements on incentive-based compensation arrangements; however, this provision only applies to companies with securities listed on a national securities exchange.

Financial Stability Oversight Council (House Version)

The Wall Street Reform and Consumer Protection Act passed by the House also included the "Financial Stability Improvement Act of 2009," which would create an inter-agency Financial Stability Oversight Council that would be responsible for identifying financial companies that are so large, interconnected or risky that their collapse would put the U.S. economy at risk. These systemically risky firms would be subject to heightened oversight, standards and regulation. The bill also establishes an orderly process for shutting down large, failing financial firms. Any costs associated with dismantling a failed firm would be paid first from the company's assets at the expense of shareholders and creditors. Any additional costs will then be covered by a $150 billion dollar "Systemic Dissolution Fund," which would be capitalized by fees assessed on financial companies with more than $50 billion in assets, on a consolidated basis, and by "financial companies *(continued on page 14)*

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that manage hedge funds" with $10 billion or more of assets under management on a consolidated basis. Such fee assessments would be based upon individual risk assessments as determined by the Council.

Financial Stability Oversight Council (Senate Version)

Senator Dodd's financial overhaul bill would similarly create an inter-agency Financial Stability Oversight Council. Significantly, in addition to collecting information from various agencies to identify and assess risk to the U.S. economy, the Financial Stability Oversight Council would have the authority, following certain procedures, to require certain U.S. and foreign nonbank financial companies to register with and be supervised by the Federal Reserve. "Nonbank financial company" is defined as a company other than a bank holding company or a subsidiary thereof that is substantially engaged in activities that "are financial in nature." This definition *may* include hedge funds and private equity funds. Senator Dodd's bill would also establish an Orderly Liquidation Authority Panel that supervises the liquidation of large, failing financial firms. An "Orderly Liquidation Fund" would be established to cover relevant costs, which would be capitalized by fees assessed on certain bank holding companies, nonbank financial companies supervised by the Federal Reserve and potentially other financial companies with more than $50 billion in assets on a consolidated basis.

Taxation of Carried Interest

On February 1, 2010, the White House released President Obama's FY 2011 Budget proposal. Among the many proposals contained in the budget were proposals to tax carried interest received in connection with a "service partnership interest" and any gain recognized on the sale of the SPI (*i.e.,* sale of the business) as ordinary income.

On December 9, 2009, the U.S. House of Representatives approved the "Tax Extenders Act of 2009." The primary purpose of the legislation is to extend for one year (through 2010) more than 40 tax relief provisions that were scheduled to expire at year-end. The legislation also contained several revenue provisions, including a provision that would tax certain carried interest income at ordinary income rates rather than at capital gains rates. The bill, which would be effective for taxable years beginning after December 31, 2009, would apply to carried interests in partnerships where the partner holds an "investment services partnership interest." An investment services partnership interest is an interest held by a person who provides advisory, management, financing and other supporting services with respect to the acquisition, holding or disposing of securities, rental real estate, interests in partnerships, commodities, or options or derivatives with respect to any of the foregoing.

In related news, on March 10, 2010, the Senate passed a tax extenders package; however, the Senate's version does not use carried interest as its main revenue offset. Instead, the Senate's version replaced carried interest with "black liquor" and "codification of economic substance doctrine" offsets.

Amendment to the Bank Secrecy Act Regulations; Reports of Foreign Financial Accounts

On February 26, 2010, the Internal Revenue Service (the "IRS") and the Financial Crimes Enforcement Network of the Department of the Treasury issued current guidance and Proposed Regulations covering a number of important issues with respect to the requirement to file Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts ("FBAR"). Most significantly for private investment funds, the IRS guidance provides that an FBAR filing is not required with respect to interests in offshore private equity and hedge funds for 2009 and earlier calendar years. Please see our March 1, 2010 client alert entitled *"FBAR Filing Not Required for Interests in Offshore Private Equity and Hedge Funds for Calendar Years 2009 and Earlier"* for further information on this topic.

Let Wall Street Pay for the Restoration of Main Street

On December 3, 2009, Representative Peter DeFazio, Chairman of the U.S. House of Representatives Subcommittee on Highways and Transit, introduced legislation entitled "Let Wall Street Pay for the Restoration of Main Street" that would assess a tax on certain securities transactions, including:

- stock transactions (tax rate = 0.25%);
- futures contracts to buy or sell a specified commodity of standardized quality at a certain date in the future, at a market determined price (tax rate = 0.02%);
- swaps between two firms on certain benefits of one party's financial instrument for those of the other party's financial instrument (tax rate = 0.02%);
- credit default swaps where a contract is swapped through a series of payments in exchange for a payoff if a credit instrument goes into default (tax rate = 0.02%); and
- options.

To ensure the tax is appropriately targeted to speculators and has no impact on the average investor and pension funds, the tax would be refunded for tax-favored retirement accounts, mutual funds, education savings accounts, health savings accounts and the first $100,000 of transactions annually that are not already exempted.

California: An Act to Amend the Political Reform Act of 1974: Placement Agents

On February 8, 2010, California Assemblyman Ed Hernandez introduced a bill requiring placement agents to register as lobbyists before pitching investment ideas to public pension plans in California. The legislation, AB 1743, would define placement agents as lobbyists in accordance with the state's Political Reform Act. Placement agents would be subject to strict gift limits, campaign contribution prohibitions, and be prohibited from receiving compensation contingent upon any investment decision by the California Public Employees' Retirement System ("CalPERS"). The placement agents, their firms and employers would be required to report quarterly on their fees and compensation and on any honoraria or gifts. The bill is sponsored by CalPERS, state Controller John Chiang and Treasurer Bill Lockyer.

Connecticut: An Act Concerning Transparency and Disclosure

On March 11, 2010, the Connecticut State Senate Banks Committee approved CT State Bill No. 5053 entitled "An Act Concerning Transparency and Disclosure." The bill would require any investment adviser to a hedge fund to "disclose to each investor or prospective investor in such hedge fund, not later than thirty days before any such investment, any financial or other interests the investment adviser may have that conflict with or are likely to impair the investment adviser's duties and responsibilities to the fund or its investors." Although the bill is intended *(continued on page 15)*

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to target hedge funds, as currently drafted, the language of the bill potentially picks up all private funds, including private equity funds and venture capital funds. According to the bill, a hedge fund is located in CT if such fund has an office in CT where employees regularly conduct business on behalf of the hedge fund.

New York: Taxpayers' Reform for Upholding Security and Transparency

On October 8, 2009, New York State Attorney General Andrew Cuomo proposed legislation entitled, "Taxpayers' Reform for Upholding Security and Transparency" ("T.R.U.S.T"), which would institutionalize Mr. Cuomo's Public Pension Fund Reform Code of Conduct, announced earlier this year, and provide additional civil, criminal and administrative penalties and sanctions to ensure firms and individuals are held accountable for violations of the new law. The legislation would:

- Replace the sole trustee that currently manages the New York State Common Retirement Fund ("CRF") with a Board of Trustees composed of 13 members. The Comptroller would chair the Board and serve alongside six members appointed by the Governor, Attorney General, Temporary President of the Senate, Speaker of the Assembly, the Senate Minority Leader and the Assembly Minority Leader. The Board's other six members would be selected by the members of CRF.
- Prohibit investment firms from using placement agents, lobbyists, or any other third-party intermediaries to communicate or interact with New York public pension funds for any purpose. The prohibition would not apply to the use of consultants and investment banks to otherwise directly assist investment firms by, for example, preparing marketing materials or performing due diligence.
- Prohibit investment firms (and their principals, agents, employees and family members) from doing business with a public pension fund for two years after the firm makes a campaign contribution to any board member. The prohibition would also apply to candidates for such positions, but would not apply to contributions of $300 or less to elected officials or candidates for whom the person making the contribution can vote.
- Require rigorous, ongoing disclosure of information relating to the identities, responsibilities and qualifications of investment fund personnel and any payments by investment firms to third parties in connection with public pension fund matters. Investment firms would be required to promptly publish such information on their websites.
- Hold investment firms to a higher standard of conduct that avoids even the appearance of impropriety. The legislation would prohibit: (i) improper relationships between pension fund officials and an investment firm's personnel or agents; (ii) "revolving door" employment by investment firms of former public pension fund officials and employees; and (iii) improper gifts by investment firms to public pension fund employees and officials.
- Require investment firms to promptly disclose and cure any actual, potential and apparent conflicts of interest to public pension fund officials or law enforcement authorities where appropriate.
- Require investment firms to certify annually that they are in compliance with key disclosure requirements.
- Institute comprehensive and tough enforcement provisions by creating tough new civil, criminal and disciplinary penalties and sanctions, and by requiring licensed professionals to report to law enforcement evidence of violations of the law. The legislation would also provide as a basis of criminal prosecution the theft of property and honest services from the retirement system, and would extend the statute of limitations for a person acting in concert with a public servant.

New York City: Restrictions Regarding Placement Agents

On February 18, 2010, New York City ("NYC") Comptroller John Liu proposed new rules regarding the use of placement agents in connection with investments by NYC pension funds. Mr. Liu seeks to make a distinction between "legitimate placement agents who provide value-added services" and those that seek to influence decision makers for a designated fee. These new restrictions must be approved by the various NYC pension boards. Here is a brief summary of the proposals taken from Mr. Liu's press release:

- Comptroller Liu will decline any campaign contributions from investment managers and their agents doing business with, or seeking to do business with, the NYC pension systems.
- Fund managers must certify that they have not given any gifts to any employees of the Comptroller's Office, nor to any employees or trustees of the NYC pension systems.
- Fund managers must disclose all contact with employees of the Comptroller's Office regarding new investments, as well as all contact with pension trustees and other individuals involved in the investment decision-making process.
- Fund managers must disclose all fees and terms relating to any firm retained to provide marketing or placement services, and that any such fees are fully paid by the fund manager.
- Fund managers must agree that the pension system(s) may terminate or rescind a contract or commitment for investment and recoup all management and performance fees for violation of these requirements.
- The current ban on private equity placement agents will be expanded to include placement agents and third-party marketers for all types of funds, where such agents and marketers are exclusively providing "finder" or introduction services.
- The current ban on private equity placement agents will be relaxed to allow use of placement agents who provide legitimate value-added services such as due diligence and similar professional services on behalf of prospective investors.
- Such agents and marketers must demonstrate the ability to raise capital outside NYC by establishing that they raised $500 million in at least two of the past three years from entities other than the NYC pension systems.
- A full description of value-added services provided as well as resumes of key professionals and employees who contact individuals involved in the decision-making process regarding a proposed investment will be required.
- Registration with either the SEC or the Financial Industry Regulatory Authority will be required.

IOSCO Publishes Systemic Risk Data Requirements for Hedge Funds

On February 25, 2010, the International Organization of Securities Commissions' ("IOSCO") Technical Committee published details of an agreed template *(continued on page 16)*

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for the global collection of hedge fund information that it believes will assist in assessing possible systemic risks arising from the hedge fund sector. The purpose of the template is to enable the collection and exchange of consistent and comparable data amongst regulators and other competent authorities for the purpose of facilitating international supervisory cooperation in identifying possible systemic risks in this sector. The template is not a comprehensive list of all types of information and data that regulators might want; so, regulators are not restricted from requiring additional information at a domestic level. The 11 proposed categories are: general manager and adviser information; performance and investor information related to covered funds; assets under management; gross and net product exposure and asset class concentration; gross and net geographic exposure; trading and turnover issues; asset/liability issues; borrowing; risk issues; credit counterparty exposure; and other issues such as complexity, number of open positions and concentration. The SEC is a member of the Executive Committee of IOSCO. As a member, the SEC agrees to adopt the principles of IOSCO. The press release states specifically, "IOSCO is publishing the template now to help inform any planned legislative changes being considered in various jurisdictions, as well as providing securities regulators the type of information authorities could gather. The Task Force has recommended that the first data gathering exercise should be carried out on a best efforts basis (given pending legislation in many jurisdictions) in September 2010." ■

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