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The Rapidly Evolving Activities of Hedge Funds

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INTRODUCTION

Over the past decade, private investment funds, including hedge funds, have experienced unprecedented growth. According to recent statistics, hedge fond assets have grown from approximately $39 billion among 610 funds hi 1990 to over 6,000 hedge funds with approximately $600 billion in assets by 2003.[1] More recently, in the first quarter of 2003, just less than $7 billion of new capital came into the hedge fund industry.[2] Industry experts predict that hedge fund assets will continue to grow at rates of upwards of 25% over the next five (5) years.[3]

Hedge funds are attracting more institutional investors such as pension plans, foundations, and endowments, as well as more mainstream investors, in record number. These types of investors represent a break, from the traditional type of hedge fund investor, namely high net worth individuals. Moreover, nearly every large mutual fund family, brokerage house, and bank, is offering, or plans to offer, hedge funds to institutional clients and wealthy individuals. Some hedge funds now have initial minimum investments as low as $25,000,[4] a far cry from the days of million dollar initial minimum investments.

Traditionally the United States has not subject, hedge funds to a comprehensive regulatory scheme. However, a number of statutes and regulations have impacted on the operations and activities of these funds .including the: 1) Securities Act., of 1933, as amended ("Securities Act"); 2) Securities Exchange Act. of 1934, as amended ("Exchange-Act"); 3) Investment Company Act of 1940, as amended ("Investment Company Ac"); 4) Investment Advisers Act of 1940 ("Advisers Act"); 5) Commodity Exchange Act ("CEA"); 6) Internal Revenue Code of 1986, as amended ("Code"); 7) Employee Retirement Income Security Act of 1974, as amended ("ERISA"); and 8) State Securities and Corporate Law.

It is beyond the scope of this outline to describe how all of the above statutes affect hedge funds. Instead, this outline is limited to the Investment Advisers Act regulation of hedge fund advisers whose principal offices and places of business are outside of the United States ("offshore advisers") that advise hedge funds organized outside of the United States arid the regulation of those hedge funds under the Investment Company Act and the Securities Act.

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1 Tremont Tass Research (a hedge fund database), TASS Asset Flows Report First Quarter 2003, cited from *Financial Times*, "Man Announces Record Raising for New Fund," July 2, 2003.

2 *Id.*

3 *Business Week*, *"Will Hedge Funds Be Overrun by All the Traffic?,"* Mar. 11, 2002 at 82.

4 *Barren's*, *"Hedging Their Bets,"* Jan. 7, 2002 at F3; Forbes, "The S500 billion Hedge Fund Folly," Aug. 8, 2001 at 70.

SECURITIES ACT ISSUES

I. INTRODUCTION

The Securities Act governs the offering process for securities in the United States and establishes civil liability for false registration statements. The Securities Act also has anti-fraud provisions with respect to the offer and sale of securities.

II. SECTION 5 OF THE SECURITIES ACT.

Section 5 of the Securities Act requires registration of each offer and sale of securities unless an exemption is available. The-registration requirements are intended, to assure that the persons selling the security give the investing public sufficient information about the issuer, the securities, and the transaction.

III. SECTION 3

Section 3 of the Securities Act exempts certain types of securities from the registration requirements of .the Securities Act. Among the exempt securities, are offerings set forth in Section 3(b), which exempts small or limited offerings whose aggregate dollar amount does not exceed $5,000,000. Section 3(b) grants the SEC rulemaking authority to add any class of securities to this exemption. The SEC exercised its rulemaking authority by adopting Rules 504 and 505 of Regulation D under the Securities Act (For a discussion of these rules, see Section A(4) below.)

IV. SECTION 4(2) OF THE SECURITIES ACT - THE PRIVATE OFFERING EXEMPTION.

Section 4(2) of the Securities Act exempts from registration “transactions by an issuer not involving any public offering.” Note that the exemption is only available to an issuer. Section 2(4) of the Securities Act defines the term “issuer” very generally to mean every person who issues or proposes to issue any security. Whether or not a particular offer and sale is a “private offering” is essentially a question of fact and necessitates a consideration of such factors as the relationship between the offerees and the issuer, the nature, scope, size, type and manner of the offering.

The Supreme Court's decision in SEC v. Ralston Purina Co., 346 U.S. 119 (1953), established the basic principle that the private offering exemption is available only for an offer and sale made privately to persons who have sufficient business and financial sophistication to be able to fend for themselves. The test applies to both offerees and purchasers. Whether an offeree or purchaser can fend for itself depends, in part, on:

A. the offeree’s and purchaser’s access to the same kind of information as would be included in a registration statement: and

B. the offeree's and purchaser's sophistication and ability to bear the economic risks of investment.

It is also important to focus on the manner in which the offering is conducted. General solicitation and general advertising are not permitted in Section 4(2) offerings.

V. <u>REGULATION D.</u>

The SEC adopted Rules 504, 505 and 506 of Regulation D to provide a safe harbor for the availability of the Section 3(b) arid 4(2) exemptions.

A. Rule 506.

Rule 506 of Regulation D, which is a safe harbor for a private offering under Section 4(2); provides an exemption for offerings of any amount by an issuer subject to certain conditions. Sales may be made to an unlimited number of accredited investors plus 35 non-accredited but sophisticated investors. Each non-accredited investor in a Rule 506 offering must have the financial sophistication necessary to evaluate the merits and risks of the prospective investment or must designate a purchaser representative who has the requisite financial sophistication: Accredited investors are presumed to be able to fend for themselves based on several objective criteria set forth in the definition of accredited investor in Rule 501. There is no limit on the number of offerees or the dollar amount raised, except that the offering cannot be made by means of general solicitation or general advertising. Of course, there are practical limits on the number of purchasers because, depending on the nature of the securities, a private issuer would not want to become a public reporting company under the Exchange Act. In addition, a large number, of investors in an offering could call into question the truly private nature of the offering. While not required to be registered under state law, Rule 506 offerings generally are subject to notice filings with certain limited exceptions.

A Notice of Sale on Form D must be filed with the SEC within 15 days of the first sale under Regulation D.

B. Rule 504.

The SEC adopted Rule 504 under its authority in Section 3(b) of the Securities Act. Rule 504 exempts offerings with an aggregate offering price of up to $1 million during any twelve-month period. There are no limitations on the number of offerees and there are no specified disclosure requirements. Rule 504 is not available to Exchange Act reporting companies, investment companies, or "blank check" companies. Securities sold in Rule 504 offerings are subject to restrictions on resales and other transfers and these offerings may not involve general solicitation and general advertising unless certain conditions are met.

C. Rule 505.

The SEC also adopted Rule 505 under its authority in Section 3(b) of the Securities Act Rule 505 exempts offerings with an aggregate offering price of less than $5 million during any twelve-month period subject to certain conditions. Sales may be made to an unlimited number of accredited investors and 35 additional persons. Also the offer cannot be made by means of general solicitation or general advertising. The rule is not available to investment companies or an issuer whose affiliates, or certain other persons associated with the offering, were, the subject of certain administrative, civil, or criminal actions.

D. Conditions Applicable to Both Rule 505 and Rule 506 Offerings.

1. Sales to an unlimited number of accredited investors are permitted;

2. Specified .information must be .furnished a reasonable amount of time prior to sale to non-accredited purchasers (anti-fraud rules under the federal securities laws apply to all investors);

3. The issuer or any person acting on its behalf is prohibited from using any form, of general solicitation or general advertising to offer or sell the securities; and

4. The securities issued will be restricted securities that cannot be .resold without registration or an appropriate exemption, and .the issuer must exercise reasonable care to assure that the purchaser is not an underwriter within the meaning of Section 2(a)(l1) of the Securities Act.

E. Differences Between Rule 505 and Rule 506.

Rule 505 limits the amount that may be raised hi a one-year period to $5 million. There is no limit on the amount that may be raised under Rule 506.

There are no sophistication requirements for non-accredited investors under Rule 505. Non-accredited investors, or their purchaser representatives, must satisfy a sophistication requirement under Rule 506.

Rule 506 offerings generally are exempt from state registration except for fees and notice filings.

F. Good Faith Compliance with Regulation D.

Rule 508 sets forth a good faith compliance defense with respect to a failure to comply with the requirements of Regulation D. Under Rule 508, the failure to comply with a term, condition, or requirement of Rule 505 or 506 will not result in the loss of the exemption for any offer or sale to a particular investor if the issuer can show that:

1. the failure to comply did not pertain to a condition directly intended to protect the particular investor;

2. the failure to comply was insignificant to the offering as a whole; and

3. a good faith and reasonable attempt was made to comply with all of the terms, conditions and requirements of the applicable exemption.

G. Who Is an Accredited Investor?

“Accredited investor” includes institutional investors - such as banks, investment companies, pension funds and corporations, trust funds - and wealthy or high earning individuals that, under the conditions set forth in the exemptive provisions, are presumed to be sophisticated in business and financial matters to be able to fend for themselves. The term also includes persons that the issuer reasonably believes fall into one of the categories at the time of sale. If sales are made by a broker-dealer, then there may be suitability requirements over and above a purchaser’s accredited investor status.

H. Integration Issues under the Securities Act.

1. Integration occurs when separate securities transactions (public and private offerings or two or more purportedly private transactions) are combined into a single offering for purposes of the Securities Act If two or more offerings are integrated, an otherwise available Securities Act exemption may be lost. . The SEC has articulated a five-factor test to determine whether separate offerings should be integrated:

- **a.** Are the offerings part of a single plan of financing?
- **b.** Do the offerings involve issuance of the same class of securities?
- **c.** Are the offerings made at or about the same time?
- **d.** Are the same types of consideration involved?
- **e.** Are the offerings made for the same general purposes?

2. Exceptions to the Integration Doctrine.

- **a.** Rule 502(a) provides an exception to the integration doctrine. Under Rule 502(a), offers and sales that are made more than six months before the start of a Regulation D offering or are made more than six months after the completion of a Regulation D offering will not be considered part of that Regulation D offering if certain specified conditions are met.
- **b.** Rule 152 under the Securities Act provides another exception. Under Rule 152, a prior, non-public offering under Section 4(2) need not be integrated with a subsequent

public offering where the prior, non-public offering was completed before the filing of the registration statement relating to the subsequent public offering. See Black Box Inc. (June 26, 1990) for a discussion of when an offering is "completed."

c. Rule 155 under Securities Act provides safe harbors for abandoned the public and private offerings. Rule 155(b) allows an issuer to begin a private offering and to terminate the private offering in order to start a registered offering without integration provided that no securities were sold in the private offering and each prospectus used in the registered, offering contains, certain disclosures including the size and data relating to the termination of the abandoned offer. An issuer contemplating switching to a private offering after having initially filed a registration statement in connection with a contemplated registered offering may also rely on the integration safe harbor contained in Rule 155(c) provided that:

1.) no securities were sold in the registered offering;

2.) the issuer withdraws the registration statement;

3.) neither the issuer nor any person acting on its behalf cormmences the private offering earlier than 30 days after the withdrawal of the registration statement;

4.) the issuer notifies each offeree in the private offering of the legal effects of participating in a private offering; and

5.) any disclosure document used in the. private offering discloses any changes in the issuer's business or financial condition that are material to the investment decision associated with the private offering.

I. General Solicitation and General Advertising.

Offers and sale of securities under Rule 506 may not be through any form of general solicitation or general advertising, including, but not limited to, the following:

Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and

Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.

The SEC, through the use of no-action letters, releases and enforcement and private actions, has defined the parameters of prohibited and permissible activities when making offers and sales under Regulation D. Restrictions on general solicitation and general advertising limit issuers from finding investors through the use of advertisements, articles, notices or other communications contained in newspapers, magazines, cold mass mailings, television or radio, web sites available to the public or e-mail messages sent to a large number of previously unknown persons.[5] For a discussion of general solicitation and advertising in connection with websites, see Section IV.I below. However, the staff has consistently held the view that a general solicitation has not occurred if there is a pre-existing, substantive relationship between the issuer and the offeree.[6] This relationship must have been established prior to the commencement of the private offering.

J. Private Offerings and the Internet (Domestic).

1. The issues raised by the use of electronic modes of communication relate to the procedural application of .the securities laws to communications by electronic media. The substantive requirements and -liability provisions of the federal securities laws apply equally to electronic and paper-based formats.

When is an electronic communication a "general solicitation?"

a. General rule - placement of offering materials on a website is a general solicitation and defeats the private placement exemption.

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5 See Rule 506 under the Securities Act; *SEC v. Inorganic Recycling Corp.*, Litig. Rel. No. 16322,1999 SEC LEXIS 2075 (Sept. 30, 1999) (holding that a. solicitation to more than 1,000 prospective investors is a general solicitation); *In the Matter of CGI Capital, Inc.,* Securities Act Release No. 7904,2000 SEC LEXIS 2081 (Sept. 29, 2000) (holding that the dissemination of thousands of e-mails to individuals, some of whom did not have any pre-existing relationship with the company, supplying passwords that allowed access to that portion of the company website containing the offering materials was a general solicitation); *In the Matter of Harry Harootunian and Professional Planning & Technologies, Inc.,* Exchange Act Release No. 32981,1993 SEC LEXIS 2504 (Sept. 29, 1993) and *In the Matter of Robert Testa,* Securities Act Release No. 7018 (Sept. 29,1993) (each holding that the mass mailing of a solicitation letter to tens of thousands of individuals who had no prior relationship with either the issuer or the sellers .of the securities was a public offering and violated the prohibition against general solicitation); *In the Matter of Kenman Corp.,* Exchange Act Release No. 21962, 1985 SEC LEXIS 1717 (April 19, 1985) (holding that the mailing of information not only to pervious investors but to an unknown number of persons, with whom no prior contact or relationship existed was a general solicitation); *In the Matter of Priority Access, Inc.,* Securities Act Release No. 8021, 2001 SEC LEXIS 2056 (Oct. 3,2001) (holding that sending approximately two million e-mails to individuals not having any pre-existing substantive relationship was general solicitation and general advertising); See also, *Circle Creek AquaCulture V, L.P.* (pub. avail. Mar. 26, 1993); *H.B. Shaine & Co.* (pub. avail. May 1, 1987); *Ovation Cosmetics, Inc.* (pub. avail. Mar. 8,1976); *Woodtrails-Seattle, Ltd.*- (pub. avail. Aug. 9,1982).

6 See, e.g., *Bateman Eichler, Hill Richards, Inc. (pub.* avail. Dec. 3,1985) (stating that since the proposed solicitation was generic and did not make reference to any specific investment currently offered or contemplated and procedures would be implemented to insure that securities offered at that time would not be offered to individuals responding to the solicitation); *E.F. Hutton Co.* (pub. avail. Dec. 3, 1985) (stating that prior investments are not necessary to. create a substantive relationship); *IPONET* (pub. avail. July 26, 1996); *Lamp Technologies* (pub. avail. May 29, 1997; May 29, 1998).

b. Exception - password-protected web pages sponsored by online brokers with certain additional limitations.

2. In IPOnet (July 26, 1996), the SEC staff determined that private placement materials may be posted on the Internet by online brokers without constituting a "general solicitation" under the circumstances described below.

a. The online broker maintains a password-protected site on its web page that has information on private placements.

b. In order to access this site and participate in any transaction posted on the .site, an investor must have a substantive relationship with the broker. A broker may establish a substantive relationship by means of an investor questionnaire. Investors must complete a questionnaire to demonstrate that they are accredited investors within the meaning of Rule 501 of Regulation D or sophisticated investors within the meaning of. Rule 506(b)(2)(ii) of Regulation D. The SEC takes the position, that merely “checking the box” regarding accredited investor status may not be sufficient for the broker to form a reasonable belief that the investor is accredited.

c. The invitation to complete the questionnaire arid the questionnaire itself must be generic in nature and not refer to specific transactions posted or to be posted on the password-protected location on the website.

d. The broker must make a determination that the investor qualifies as an accredited investor or sophisticated investor.

e. Investors who qualify are given a password that allows them access to password-protected pages on the website.

Investors who qualify are only allowed to purchase securities in transactions that are posted on the password-protected page after that investor's qualification as an accredited or sophisticated investor.

3. **There are three considerations in applying Rule 144A:**

a. Eligible purchasers;

b. Eligible securities; and

c. Available information.

4. In Lamp Technologies (May 29, 1997), the SEC staff took the position that private funds (relying on Regulation D and Section 3(c)(l) or Section 3(c)(7) of the Investment Company Act) may provide information regarding their funds, including offering memoranda, to a third party that would post that information on the Internet. In addition to the questionnaire requirement stated in IPOnet, the staff also conditioned its relief on the payment of a subscription fee by the subscriber. The staff noted that there would be a 30-day waiting period from the time the subscriber joined before the subscriber could purchase a. posted fund. This 30-day waiting period was substituted for the procedure in IPOnet because of the continuous nature of private fund offerings in Lamp. There were several funds posted so the underlying theory is that the solicitation was not for any one fund. There is a question of applicability if this procedure is used for a single fund.

5. In Use of Electronic Media, Release No. 33-7856 (May 1, 2000), the SEC also noted that industry practice often deviates from the facts in IPOnet and that third party service providers who are neither registered as broker-dealers nor affiliated with registered broker-dealers are establishing websites and are inviting prospective investors to prequalify. The SEC stated that sites that allow for self-accreditation "raise significant concerns .as to whether the offerings they facilitate involve general solicitation." The SEC also suggested that such website operators should consider whether they need to register as broker-dealers.

VI. REGULATION S OFFSHORE OFFERS.

A. Introduction

Regulation S was adopted to provide guidance and a safe harbor from the registration requirements of the Securities Act. Section 5 of the Securities Act makes it unlawful for any person, directly or indirectly to make use of any means or instruments of transportation or communication in "interstate commerce" or the mails to offer or sell securities without registering the securities under the Securities Act. Interstate, commerce is defined in Section 2(7) of the Securities Act to include "trade or commerce in securities or any transportation or communication relating thereto . . . between any foreign country and any State, Territory, or the District of Columbia." As such, the potential jurisdictional reach of Section 5 is quite broad and may include foreign offerings that do not comport to other exemptions to registration such as the U.S. Private Offering Exemption (e.g., Regulation D and/or Section 4(2) of the Securities Act).

The SEC's initial attempt to clarify the jurisdictional boundaries in this area was through Securities Act Release No. 4708 (July 8, 1964), which rather imprecisely took the position that an offering sold in a manner reasonably designed to preclude distribution or redistribution within or to nationals of the United States did not require registration under Section 5. After 25 years and numerous No-Action Letters,[7] the. SEC in Securities Act Release No. 6863 (Apr. 24, 1990) adopted Regulation S, which provides explicit safe harbors for offshore distributions and resales of unregistered securities of U.S. and foreign issuers.

Regulation S states as a general statement (Rule 901) that the registration requirements of Section 5 of the Securities Act do not apply to "offers and sales of securities that occur outside the United States." Regulation S sets forth two safe harbor provisions. The two safe harbor provisions describe conditions under which the SEC will deem the offers and sales to have occurred "outside the United States" within the meaning of the general statement.

1. The "issuer safe harbor" (Rule 903) applies to offers and sales by issuers, persons involved in the distribution process pursuant to contract ("distributors"), their affiliates and any person acting for those persons..

2. The "offshore-resale safe harbor" (Rule. 904) applies to offshore resales by persons other than those eligible to rely upon the issuer safe harbor. This safe harbor may be relied upon by officers and directors who are affiliates of the issuer or a distributor solely by virtue of holding such position.

The safe harbors do not create a presumption that a transaction that fails to meet their terms is subject to the registration requirements of Section 5 or is a violation of Section 5.

Equity securities of U.S. issuers that are sold pursuant to Regulation S are deemed to be "restricted securities" and are not freely resaleable in the United States for at least one year after sale.

Regulation S is not applicable to the offer ad sale of securities issued by openend investment companies or unit investment trusts registered (or required to register, but not registered) under the Investment Company Act.

B. General Conditions.

The following two general conditions apply to both the issuer safe harbor and the offshore resale safe harbor:

1. Any offer or sale must be made in an "offshore transaction." In order for a transaction to be an offshore transaction, several requirements must be satisfied:

a. no offers may be made in the United States; and

b. either:

[7] *See,. e.g., InfraRed Assocs., Inc.* (pub. avail. Sept. 13, 1985); *Proctor &. Gamble Co.* (pub. avail. Feb. 21, *1985)*; *Fairchild Camera & Instrument Int'l Fin. N.V.* (pub. avail. Dec. 15, 1976); *Raymond Int'l, Inc.* (pub. avail. June 28, 1976); *Pan Am. World Airways, Inc.* (pub. avail. June 30, 1975); *Singer Co.* (pub. avail. Sept. 3, 1974).

1.) the buyer must be outside the United States at the time the buy order originates (or the seller reasonably believes the buyer is offshore), or

2.) one of the following:

a.) for persons relying on the issuer safe harbor, the sale must be made in, on or through a physical trading floor of an established foreign securities exchange; or

b.) for persons relying on the offshore resale safe harbor, the sale must be made in, or through the facilities of a "designated offshore securities market," and the transaction may not be pre-arranged with a buyer in the United States.

2. No directed selling efforts may be made in the United States. "Directed selling efforts" are those activities that could reasonably be expected, or are intended, to condition the U.S. market for the securities being offered in reliance on Regulation S. Regulation S sets forth specific types of activities that are not viewed as directed selling efforts. For example, an advertisement that is required to be published by foreign or U.S. law or stock exchange regulations will not be deemed directed selling efforts if the advertisement does not contain more information than what is legally required and contains a specified legend.

C. Additional Conditions.

Rule 903 (the Regulation S issuer safe harbor) details three categories of issuers or offerings, based on the level of connectedness with the U.S. market. The category of issuer determines the nature of the additional conditions.

1. Category 1.

No conditions apply other than the two general conditions listed above. This category applies to the following issuers or offerings:

a. "foreign issuers" (including "foreign private issuers") who reasonably believe that there is no substantial U.S. market interest in the securities being offered;

b. an "overseas directed offering" into one country;

c. securities backed by full faith and credit of a foreign government; and

d. securities issued in connection with foreign employee benefit plans.

2. Category 2.

This category applies to equity securities of a reporting foreign issuer, or debt securities of a reporting issuer or of a non-reporting foreign issuer. The issuer safe harbor is available for a Category 2 offering if the two general conditions described above are satisfied. In addition, the following requirements apply:

a. offers, and sales of securities to U.S. persons (other than a distributor) before the end of a 40 day distribution compliance period are prohibited;

b. distributors must send a confirmation to certain purchasers during the 40 day distribution compliance period; and

c. certain offering restrictions, described in Rule 902(g) must be implemented.

3. Category 3.

Category: 3, is a residual category. The additional conditions for Category 3 include that "offering restrictions" are implemented; sales to U.S. Persons are prohibited during a specified distribution compliance period; and legends and restrictions on transfer of the securities are imposed. In the case of .debt securities, the distribution, compliance period is 40 days. In the case of equity securities, the distribution compliance period is one (1) year;

Rule 902(k) defines the term "U.S. person", for purposes of Regulation S. In pertinent part, U.S. residency rather than U.S. citizenship is the principal factor in the test of a natural person's status as a U.S. person. In Investment Funds Institute of Canada (pub. avail. Mar. 4, 1996), the SEC clarified that "Offshore Funds must count all United States residents to whom they sell their securities, as well as any transferees of United States residents who purchase securities in private offerings in the United States, but generally need not count United States residents that purchase securities in bona fide secondary transactions outside the United States or the transferees of such United States residents."[8] For business entities, the place of incorporation or formation generally controls.[9] A foreign subsidiary or branch located in the United States is treated as a U.S. person. Conversely, U.S. subsidiaries or branches located outside the United States are not treated as U.S. persons, if they (1) operate for valid business reasons; (2) are engaged in the banking or insurance

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8 *Wilmer, Cutler & Pickering* (pub. avail. Oct. 5, 1998) at note 11 citing *Investment Funds Institute of Canada* (pub. avail. Mar. 4, 1996).

9 *See Goldman, Sachs & Co.* (pub. avail. Oct. *3*, 1985).

business; and (3) are subject to substantive local banking or insurance regulation.[10]

D. Resale Safe Harbor.

The SEC adopted Rule 905 in Securities Release No. 7505 (Feb. 17, 1998) (the "1998 Release"), which classifies "equity securities placed offshore by domestic issuers under Regulation S . . . as 'restricted securities' within the meaning of Rule 144, so that resales without registration or an exemption from registration will be restricted." In the 1998 Release, the SEC stated mat it expressly defined Regulation S equity securities of U.S. issuers as "restricted securities" under the Rule 144 resale safe harbor so that purchasers of those securities are provided with clear guidance regarding when arid how those securities may be resold in the United States without registration under the Securities Act.

E. Foreign Stock Exchange Listing.

1 . Many offshore .funds list their shares for trading on foreign stock exchanges, such as the Irish, Hong Kong, Cayman Islands and. Bermuda stock exchanges. For closed-end funds, such listings may provide potential liquidity for investors. Even open-end funds may list on foreign exchanges, however, because the investment policies and restrictions applicable to many foreign institutional investors permit them to more easily invest in exchange-listed securities. Each exchange maintains its own listing requirements and restrictions.

For Category 3 issuers-, the SEC has issued a series of No-Action Letters regarding securities listing on foreign exchanges.[11] All three letters provided No-Action assurance for foreign exchanges offering equity securities of non-reporting U.S. companies. In these letters, the SEC permitted alternative restrictions and procedures from Rule 903(b)(3)(iii)(B) to be used in the initial offering and resale of such securities provided.

F. Offshore Offers on the Internet.

1. The SEC issued an interpretive release hi March 1998 that clarified when the posting of offering or solicitation materials on Internet websites would not be considered to be activities taking place "in the United States." See Securities Act Release No. 7516 (March 23, 1998). The interpretive releases only, address when materials posted on the Internet may be deemed not to be offers "in the United States" and did not alter the basic requirements that all offers and sales within the United States must be registered or exempt.

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10 *See Foreign Agencies & Branches of United States Banks & Ins. Cos.* (pub. avail. Feb. 25, 1988).

11 See European Association of Securities Dealers Automated Quotation N.V./S.A. ("EASDAQ") (pub. avail July 27, 1999); Australian Stock Exchange Ltd. (pub. avail. Jan. 17, 2000); OM Stockholm Exchange (pub. avail. Oct. 11, 2000); Cairo and Alexandria Stock Exchanges (pub. avail. Apr. 16, 2003).

2. Whether the registration provisions of the U.S. securities laws apply depends on whether Internet offers, solicitations or other communications are targeted at the United States. This depends on whether adequate measures are implemented that suffice to guard against sales to U.S. persons. Whether adequate measures have been implemented to guard against sales to U.S. persons depends on the facts, and circumstances of the situation. The interpretive release provides some guidance,, however, to indicate procedures that generally would be considered to be adequate measures. The measures that should be taken vary depending on whether the offering is made by a foreign or a U.S. offeror or whether the offeror uses a third party website to make or promote the offering.

3. Offshore Internet Offerings by Foreign Offerors.

   Generally, an offshore Internet offer by a foreign offeror would not be treated as .targeted at the United States, if the offeror implements the following measures:

   a. the website that :posts the offer contains a prominent disclaimer making it clear that the offer is directed only to countries other than the United States; and

   b. the offeror implements procedures reasonably designed to prevent sales to U.S. persons in the offshore offering. For example, the offeror could determine the purchaser's residence before the sale.

   These measures are not exclusive. Offerors may adopt other measures as long as the procedures suffice to guard against sales to U.S. persons. Sham offshore offerings .or procedures, however, will not allow offerors to escape their Section 5 obligations.

4. Offshore Internet Offerings by Foreign Offerors When There Is Also a U.S.-Exempt Component of the Offering.

   If a foreign issuer makes an offshore Internet offering concurrently with a U.S. private placement, it must not make a general solicitation in the United States that would jeopardize its eligibility to rely on the Section 4(2) exemption or Regulation D. The website may not be used as a means to locate investors to participate in the U.S. private placement. Because of the risks posed when the issuer is conducting concurrent offshore public and U.S. private offerings, the offeror should take further precautions in addition to the two listed above. . The release suggests two additional precautions that could be used in these situations:

a. the Internet offeror could allow unrestricted access to the offshore Internet offering materials, but not permit a person responding to the offshore Internet offering to participate in the U.S. exempt offering, even if the person is otherwise qualified to participate; or

b. the Internet offeror could ensure that access to the posted offering materials is limited to viewers who first provide residence information indicating that they are not U.S. persons.

5. Offshore Internet Offerings by U.S. Issuers.

U.S. issuers must take additional precautions to prevent their offerings over the Internet from being targeted at the United States. As a result, U.S. offerors must take the basic precautionary measures that foreign offerors do, and also implement additional precautionary measures similar to password protection that are reasonably designed to ensure that only non-U.S. persons have access to the offer. Persons seeking access to the site would have to demonstrate that they are not U.S. persons before they would be given the password.

INVESTMENT COMPANY ACT ISSUES

I. DEFINITION OF INVESTMENT COMPANY

A. The Investment Company Act contains two definitions of investment company pertinent to hedge funds.

Section 3(a)(l) of the Investment Company Act defines "investment company" to include any entity that is, or holds itself out as being, primarily engaged in the business of investing, reinvesting or trading in securities. Section 3(a)(l)(C) of the Investment Company Act defines "investment company" as an entity that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading securities if over 40% of its total assets are invested in "investment securities" as defined in the Investment Company Act. As used in Section 3(a)(l)(C), "investment securities" include "all securities except (a) government securities, (b) securities issued by employees' securities companies, and (c) securities issued by Majority-Owned Subsidiaries of the owner which are not investment companies." (Emphasis Added.)

This section covers entities which, by virtue of their asset composition, qualify as investment companies.

B. There are three primary differences between Section 3(a)(l)(A) and Section 3(a)(l)(C). First, Section 3(a)(l)(A) requires the issuer to be "primarily" engaged in the business of investing in securities, while Section 3(a)(l)(C) requires only that the issuer be "engaged" in that business. Second, Section 3(a)(l)(A) applies to issuers that invest in any type of "security", while Section 3(a)(l)(C) applies only to "investment securities." Third, Section 3(a)(l)(A) does not apply to issuers that merely "own" or "hold" securities, while Section 3(a)(l)(C) applies to such issuers. In practice, however, the distinction between the two sections often is blurred.[12]

II. REGULATION OF REGISTERED INVESTMENT COMPANIES

The Investment Company Act regulates open- and closed-end investment companies, as well as their advisers and principal underwriters. The Investment; Company Act requires all-investment companies to register unless they qualify for an exemption from registration under the Investment Company Act.

A. Private Investment Companies - Exemptions from Registration.

The most important exemptions from registration are contained in Investment Company Act Sections 3(c)(l) and 3(c)(7). Funds relying on these sections are typically referred to as "private investment companies" because they must not make or propose to make a. public offering of its securities to qualify for exemption from registration as an investment company under either Section.

Section 3(c)(l) excludes issuers from the definition of an investment company if that issuer's outstanding securities are held by no more than 100 persons. Section 3(c)(7) exempts issuers from such definition if that issuer's outstanding securities are owned only by qualified purchasers.

1. 100 Owner Funds Exclusion.

a. Basic Requirements.

Section 3(c)(l) excludes from registration ah investment company that (1) has 100 or fewer beneficial owners and (2) meets the private offering requirement. The rationale for this exclusion from registration is that these investment vehicles represent small pools of assets that do not warrant SEC regulation.

b. Beneficial Ownership.

Normally, a single investor in a private fund is counted as a single beneficial owner of that fund. However, the SEC has noted that a person may have beneficial ownership if that person may determine whether and how much to invest.

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[12] *See* SEC v. Fifth Avenue Coach Lines. Inc., 289 F. Supp. 3 (S.D.N.Y. 1968), aff'd, 435 F.2d 510 (2d Cir.1970) (district court concluded that issuer was an investment company under both sections).

1.) Partnerships and Retirement Accounts.

General partner(s) of a partnership, for example, will be the sole beneficial owner(s) if the decision to invest rests with those general partner(s).
However, beneficial ownership rests with the limited partners when a general partner consults with the limited partners about their investment objectives and varies, from -investment to investment, each limited partner's percentage share of profits and losses based on individual circumstances. See WR Investment Partners (April 15, 1992). In addition, plan participants of self-directed 401 (k) retirement plans will be deemed the beneficial owners as they may decide whether and-how much to invest. See PanAgora Trust (April 29, 1994).

2.) Joint Ownership.

A n investment in a private fund that is jointly owned by a husband and his wife will be considered to be owned by a. single owner. This interpretation, however, does not extend to family dependents. See American Bar Association (April22, 1999) ("ABA Letter").

c. Knowledgeable Employees.

A "knowledgeable employee," as defined in Rule 3c-5 under the Investment Company Act, is. a natural person who is (1) an executive officer, director, trustee, general partner,, advisory board member or other person serving in a similar capacity of a private fund or ah affiliated management person, or (2) an employee of a private fund or an affiliated management person who regularly participates in. the investment activities of such fund (or certain of its affiliates) and has been employed for at least 12 months.

1.) Basic Premise.

The basic premise is that knowledgeable employees, due to their financial knowledge and relationship to a private fund, have the financial sophistication to understand the risks associated with the purchase of such company's securities. Therefore, a knowledgeable employee is not counted toward the 100 person limit of a Section 3(c)(l) fund.

2.) Who are not Knowledgeable Employees?

The SEC interprets knowledgeable employees to include those employees that actively participate in the investment activities of a private fund. Generally, the following persons will not be knowledgeable employees and, thus, must be counted toward the beneficial owner and qualified purchaser limitations: investor relations professionals, research analysts, brokers, traders, attorneys, compliance, officers and operational persons. See ABA Letter.

3.) Affiliated Management Person.

Generally, knowledgeable employees are limited to persons whose employer is the private fund's manager. In cases where an affiliated company is under common control with the manager, and the company and manager have the same parent company, employees of the affiliated company could be knowledgeable employees because they will have significant access to information about the private fund. See ABA Letter.

4.) Timing.

A natural person will be a knowledgeable employee if he or she was such an employee at the time the private fund's securities were purchased. In addition, a person may be treated as having been a knowledgeable employee at the time of prior purchases even though that person's status did not arise until later. See ABA Letter. A knowledgeable employee need not dispose of the securities upon termination of employment. See Privately Offered Investment Companies, Investment Company Act Release No. 22597 (April 3, 1997).

5.) Look-Through Rule.

Generally, a company (as opposed to a natural person) is treated as a single beneficial owner. Accordingly, a company that purchases a private fund's securities would be treated as one owner for purposes of the 100 beneficial owner limit pursuant to Section 3(c)(l). However, to prohibit companies from doing indirectly what they cannot do directly, i.e., pyramiding their investments in private funds to avoid the Investment Company Act's registration requirements while in effect operating an investment company subject to registration, the "look-through" rule applies. The "look-through" rule treats the number of beneficial owners of the investing company (rather than the investing company itself) as the beneficial owners of the private fund, if (1) the investing company owns 10% or more of the Section 3(c)(l) fund's-voting securities, and (2) the investing company is itself an investment company or private fund. For example, the SEC imposes a rebuttable presumption that an entity was not formed for the specific purpose of making an investment in a Section 3(c)(l) fond if not more than 40% of its committed capital is invested in the Section. 3(c)(l) fund and the investors in the entity have no individual investment discretion over their assets in the entity. See Cornish & Carey Commercial, Inc. (June 21, 1996).

2. Qualified Purchaser Exemption.

a. Basic Requirements.

Section 3(c)(7) exempts from registration an Investment company, that (1) has only "qualified purchasers" as investors (although the investment company may have an unlimited number of them) and (2) meets the private offering requirement Qualified purchaser funds must, however, take care to have no more than 499 record holders of their securities or they may be required to register their securities under Section 12(g) of the Exchange Act.

b. Qualified Purchasers.

Generally, qualified purchasers are natural persons that own at least $5 million in "investments" and institutional investors that own and invest on a discretionary basis at least $25 million in "investments.""

1.) Definition.

Section 2(a)(51) under the Investment Company Act, as modified by Rule 2a51-3, defines qualified purchasers as including:

a.) a natural person who owns at least $5 million in investments;

b.) a company that was not formed for the specific purpose of acquiring the securities offered, that owns at least $5 million in investments and is owned by two or more related natural persons (a so-called "family company");

c.) a trust that was not formed for the specific purpose of acquiring the securities offered, where the trustee and each person who contributes assets to the trust is a qualified purchaser; and

d.) any person that was hot formed for the specific purpose of acquiring the securities offered, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, at least $25 million in investments.

Both a "knowledgeable employee" and a company owned exclusively by knowledgeable employees can also invest in a Section 3(c)(7) fund. See also Section G(l)(b)(iii) above.

2.) Exceptions.

In addition, Rule 2a51-l provides that, with two exceptions, QIBs, as defined hi Rule 144A under the Securities Act, will be deemed to be qualified purchasers.

a.) The first exception relates to-dealers. To coordinate the definition of QIB with the statutory definition of qualified purchaser, Rule 2a51-l requires, a dealer to own and invest on a discretionary basis $25 million in securities of issuers that are not affiliated, persons of the dealer (rather than .Rule 144A's $10 million requirement).

b.) The second exception relates to employee benefit plans under the new rules. Under Rule 2a5l-l, a self-directed employee benefit plan, including a 401(k) plan, is not itself considered a qualified purchaser if investment decisions are made by the beneficiaries of the plan.

3.) Investments.

The term "investments" is defined in Rule 2a51-l to mean the following when they are held for an investment purpose: securities, real estate, commodities, financial contracts, cash, and cash equivalents.

a.) In determining the amount of the investments, all indebtedness associated with the investments must be deducted.

b.) Real estate owned for residential purposes or to enable the investor to conduct his or her business is not included in calculating the amount of “investments.”

c.) Artwork, antiques and other similar property also are excluded from the definition of investments. These are excluded because they do not indicate any experience on the part of the investor in the financial marketplace.

d.) With the exception of an installment purchaser, an investor in a Section 3(c)(7) fund must be a qualified purchaser each tune he or she invests in the fund. If the investor's level of investments subsequently falls below qualified purchaser status, this event will not disqualify the fund from, the Section 3(c)(7) exemption, but the investor will be unable to make additional purchases.

e.) If a client has made a binding commitment to invest in installments, his or her status will normally be tested only once, at the time he or she makes the original binding commitment. In these cases only, reconfirming the client’s status will not be necessary for subsequent installments if the client was a qualified purchaser at the time he or she made the commitment.

4.) Reasonable Belief.

For all other investors, the fund, through due diligence efforts, must form a reasonable belief that the investor is a qualified purchaser each time he or she makes additional investments.

5.) Treatment of Trusts and Trustees.

Consistent with Rule 2a51-l(g)(4), in cases of multiple trustees, the qualified purchaser test is applied to the trustee responsible for making investment decisions on behalf of the trust. Moreover, a trust will only be considered a qualified purchaser where both the trustee(s) and the settlor(s) are qualified purchasers. See ABA Letter.

a.) Timing Concerns.

A trustee will be considered to be a qualified purchaser when he or she makes the decision to acquire a private fund's securities. A settlor will be considered a. qualified purchaser when he or she makes the decision to contribute assets to the trust. Additionally, a settlor will continue to satisfy the qualified purchaser, requirement even though he or she may not be qualified at the time of subsequent contributions if he or she was qualified at the time of the initial contribution. See ABA Letter.

6.) Aggregation Matters.

a.) Joint Ownership.

Rule 2a51 -1 (g)(2) permits a spouse to include in the amount of that person's investments any investments held jointly with his or her spouse. In addition, spouses may aggregate their ownership so that both may be treated as qualified purchasers, even though one may not technically qualify.

b.) Multiple Legal Entities.

As noted above, Rule 2a51-l provides that qualified purchasers include persons acting for their own accounts or the accounts of other qualified purchasers who in the aggregate own at least-$25 million in investments.

i.) A trustee maintaining discretionary power over $25 million in investments in the aggregate will be deemed a qualified purchaser even though individually he or she owns less man $25 million. See Service Corporation International (October 6, 1998) ("Service Corporation"). This is in contrast with the notion that plan participants of 401 (k) plans must satisfy the qualified purchaser limitation if such participants could direct the investment of their funds.

ii.) The investments of a subsidiary may be aggregated with those of its majority-owned subsidiaries and its parent company in order to meet the $25 million threshold. See Service Corporation.

c.) Look-Through Rule.

Since Section 3(c)(7) funds can have an unlimited number of qualified purchasers, the "look-through" rule normally is not relevant. However, an entity that has been formed for the specific purpose of making an investment in a Section 3(c)(7) fund is not itself a-qualified purchaser unless each of its beneficial owners is also a qualified purchaser. Whether an entity is considered to be formed for the specific purpose of making an investment in a Section 3(c)(7) fund is a factual question that has not been answered by the statute, rules or interpretive materials. Some guidance may be taken from interpretation of the same issue in the context of Section 3c)(l) funds. See Section G(l)(b)(iv) above.

3. Conversion From Section 3(c)(l) to Section 3(c)(7).

a. Basic Requirements.

A Section 3(c)(l) fund may convert to a Section 3(c)(7) fund to be able to exceed the 100 beneficial owner limit. Because a conversion is a substantial change in the form of the private fund, the following conditions must be satisfied:

i.) all investors in the private fund, including qualified purchasers, must be given (1) notice that in the future the fund can have more than 100 investors and that any new investors must be qualified investors and (2) an opportunity to have their shares redeemed at net asset value; and

ii.) a converted Section 3(c)(7) fund must satisfy the condition that, in addition to qualified purchasers, its outstanding securities are beneficially owned by no more than 100 persons who are not qualified purchasers, and (1) such persons must have acquired any portion of the securities- of such issuer on or before September 1, 1996 and (2) at the time at which such persons initially acquired the securities of such issuer, the issuer must have been excepted by Section 3(c)(l).

b. Trusts, Retirement Vehicles and Knowledgeable Employees.

A Section 3(c)(l) fund that converts to a Section 3(c)(7) fond may accept additional investments from current owners through trusts and retirement vehicles ("Instrument") if the owner (1) owns the Instrument, (2) makes all investment decisions, and (3) the investments are for the benefit of the employee. See ABA Letter.

c. Limited Partnership.

A Section 3(c)(l) LP that converts to a Section 3(c)(7) LLC would not need to re-determine whether the holders of the Section 3(c)(7) interests are qualified purchasers if (1) the change in legal form does-not result in any material change in the investors' interests arid (2)the-LLC is substantially the same business and enterprise. See ABA Letter.

4. Integration.

a. Integration Principle.

An investment manager can manage more than one privately, offered fund. However, the "integration principle" prevents investment managers from circumventing the 100 beneficial owner limit by setting up several Section 3(c)(l) funds that are essentially a single fund.

b. Application.

Under this principle, the SEC will aggregate the number of beneficial owners of all funds managed by a single manager that are not "sufficiently different" from one another. The SEC's standard for "sufficiently different" is that "a reasonable purchaser would view an interest in an offering as not materially different from another." Therefore, to avoid operating an investment company in violation of the Investment Company Act registration requirements, investment managers must ensure that each Section 3(c)(l) fund is "sufficiently different" from every other Section 3(c)(l) fund managed by that manager.

c. Converted Funds.

The integration principle usually is not relevant to Section 3(c)(7) funds because these funds are permitted to have an unlimited number of qualified purchasers. However, the integration rules will be applied to certain Section 3(c)(7) funds that were converted from a Section 3(c)(l) fund,

d. Section 3(c)(l) and Section 3(c)(7) Funds.

Pursuant to Section 3(c)(7)(E) of the Investment Company Act, a parallel Section 3(c)(l) fund will not be integrated with a Section 3(c)(7) fund even if they are otherwise identical.

B. Section 7(d) of the In vestment Company Act

1. Section 7(d) prohibits a fund organized outside the United States from using U.S. interstate commerce to make a public offering of its Shares.[13] However, Section 7(d) does not prohibit a foreign fund from making a private offering of its securities through interstate commerce without registering under the 1940 Act. The SEC Staff ("Staff") holds that an offering that complies with Rule 506 of Regulation D ("Rule 506") will be deemed a private offering for Section 7(d) purposes.[14]

2. The Staff interprets Section 7(d) to allow a Foreign Fund to privately offer its securities Onshore, coincident with a-public offering of its securities Offshore ("Touche Remnant Doctrine"), provided that: (1) the Onshore offering complies with Rule 506;[15] (2) the coincident public Offshore offering complies with Rule 903 of Regulation S; and (3) the Foreign Fund's shares in the aggregate are beneficially owned by no more than 100 U.S. residents.[16]

3. The SEC staff has also stated that a private investment company will not violate Section 7(d) of the Investment Company Act (which prohibits foreign funds from, conducting a public offering

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[13] Section 7(d) provides La relevant part that "[n]o investment company, unless organized or otherwise created under the laws of the United States or of a state . . . shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to offer for sale, sell or deliver after sale, in connection with a public offering, any security of which such company is the issuer." Section 7(d) allows the Securities and Exchange Commission ("SEC") to issue an order permitting a Foreign Fund to register under the 1940 Act and make a public offering of *its* securities if it finds that, "by reason of special circumstances or arrangements, it is both legally and practically feasible to enforce the provisions" of the 1940 Act against the Foreign Fund. Except for Canadian organized funds, the SEC has rarely granted an order under Section 7(d).

[14] *See* Global Mutual Fund (pub, avail. July 14, 1992); Fonlyser (pub. avail. August 14, 1991).

[15] This rule is widely known. Therefore, a copy of the rule is attached to this memorandum, in lieu of a lengthy discussion.

[16] Touche. Remnant & Company (pub. avail. August 27, 1984) ("Touche Remnant Letter"). *See also* Resale of Restricted Securities: Changes to Method of Determining Holding Period of Restricted Securities under Rules 144 and 145. Sec. Act Rel. No. 6862 (April 23, 1990) (where the SEC itself endorsed the Touche Remnant Doctrine).

in the United States) if it privately offers and sells its securities in the United States to an unlimited number of qualified purchasers in accordance with Section 3(c)(7) of the Investment Company Act.[17] However, The offshore fund generally must qualify under either Section 3(c)(l) or Section 3(c)(7) with respect to its U.S. offers and sales. The offshore fund cannot rely on both provisions simultaneously.

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17 See Goodwin, Procter & Hoar (February 28, 1997); see also ING Bank, N.V., 2002 SEC No-Act. LEXIS 633 (July 8, 2002).

INVESTMENT ADVISERS ACT

I. INTRODUCTION

The Advisers Act regulates the activities of federally registered investment advisers. To be registered under the Investment Advisers Act, an investment adviser must have 15 or more clients. In the past, the Advisers Act treated a hedge fund as an investment adviser's client and not the hedge fund's underlying investors. Consequently, investment advisers that only provided advice to hedge funds were exempt from registration under the Investment Advisers Act unless they provided advice to 15 or more hedge funds. However, on October 26, 2004, the SEC adopted a new rule and rule amendments under the Advisers Act that will require most hedge fund managers to register with the SEC as investment advisers. The new rule will require an adviser to a private fund ("Private Fund") as defined by the rule to "look through" the fund and to count the number of investors in the fund (rather than the fund) when counting the number of the fund's clients; The new registration rule will require investment advisers located in the United States and offshore investment advisers that operate Private Funds that have 15 or more United States investors to register with the SEC as investment advisers and to be regulated by the Advisers Act

II. REGULATION OF PRIVATE FUND ADVISER

A. Definition of Private Fund

A Private Fund is now defined by amended Rule 203(b)(3)-l in reference to three .characteristics that differentiate hedge funds from other pooled investment vehicles such as private equity funds or venture capital funds. These three characteristics are:

1. Reliance on Section 3(c)(l) or 3(c)(7) of the Investment Company Act. A Private Fund includes those entities that would fall within the definition of an investment company if not for its reliance on Sections 3(c)(l) or 3(c)(7) of the Investment Company Act. This definition serves to exclude business organizations, including insurance companies, broker-dealers and banks.

2. Application of Two-Year Lock Up. A Private Fund includes those entities that allow investors to redeem, their ownership interests within two years of purchase. A fund can offer redemption rights under extraordinary circumstances without being considered a Private Fund.[18] This two-year lock-up applies to any new

[18] Rule 203(b)(3)-l(d)(2) provides that a fund will not violate the two-year lock up period if it permits its owners to redeem interests: (i) under events found by the investment adviser, after reasonable inquiry, to be extraordinary; or (ii) acquired through the reinvestment of distributed capital gains or income. The adopting release details events that would be considered extraordinary under the rule. Circumstances under which a redemption during the two-year period would be allowed include: (i) when continuing to hold the investment becomes

investment made in a Private Fund by any new or existing investor on or after the compliance date of February 1, 2006.

3. Advisory Skills, Ability or Expertise. A Private Fund includes those entities whose interests are offered based on the investment advisory skills, ability or expertise of the investment manager.

B. Method of Counting Clients in Private Funds for purposes of Registration (Rule 203(b)(3)-2)

New rule 203(b)(3)-2 requires an investment adviser to look through each Private Fund that it advises and count each shareholder, limited partner, member or beneficiary of a Private .Fund as a client for purposes of determining if the investment adviser is able to take, advantage of the private advisers exemption in Section 2Q3(b)(3) of the Advisers Act If the investment adviser also advises individual client accounts, it must aggregate those clients with any Private Fund investors for purposes of calculating the number of clients. The investment adviser will not be able to take, advantage of the private adviser exemption if it advised more than 14 clients during the preceding 12 months.[19] If an investor in a Private Fund advised by the investment adviser is itself a Priviate Fund, the investment adviser must look through that Private Fund when determining the number of clients. However, an investment adviser is not required to count itself as a client and is not required to count as clients certain knowledgeable, advisory personnel.[20]

C. Regulation of Offshore Hedge Funds advised by Registered Offshore Advisers

Rule 203(b)(3)-2 and amended Rule 203(b)(3)-l contain provisions that apply specifically to investment advisers who have their principal offices and places of business

impractical or illegal; (ii) when an interest owner dies or becomes totally disabled; (iii) when key personnel at the . adviser die, become incapacitated,, or cease to be involved in the management of the fund for an extended period of time; (iv) the merger or reorganization of the fund; (v) avoiding a materially adverse .tax or regulatory outcome; and (vi) preventing the fund's assets from being considered “plan assets” under the Employee Retirement Income Security Act of 1974, as amended (“ERISA”). The SEC, in adopting Rule 203(b)(3)-l, stated that funds could use a “first in, first out” method of determining the age of purchases and capital contributions. The two-year lock .up period also will not prevent the general partner of, or adviser to, the fund from initiating distributions payable to all owners, or a class of owners, in accordance with the fund's governing documents. Such distributions are distinguishable from redemptions in that they are not initiated by the investor. In addition, the transfer by an investor of his interest to a new limited partner in a secondary market transaction is not considered a redemption.

[19] The SEC will only apply the new counting rule, prospectively from the compliance date.

[20] An investment adviser is not required-to count as a client: (i) an executive officer, director, trustee, general partner, or person serving hi a similar capacity, of the investment adviser; and (ii) an employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the investment adviser) who, in connection with his or her regular functions or duties, participates in the investment, activities of the investment adviser, provided that such employee has been performing such functions and dirties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company, for at least 12 months. In addition, an investment adviser is not required to count as clients certain relatives of such knowledgeable advisory personnel. Such relatives include minor children of such knowledgeable advisory personnel and any relative, spouse, or relative of the spouse who have the same principal residence as such knowledgeable advisory personnel.

located outside the United States. Such an offshore adviser must look through any Private Fund it manages and only count those investors who are U.S. residents as clients for purposes of the 14-client threshold. The determination of whether a client is a non-U.S. client[21] or a U.S. client need only be made at the time of the original investment. If the offshore adviser has more than 14 clients who are U.S. clients, it must register with the SEC regardless of the amount of its assets under management.[22]

1. <u>Exception for Offshore Publicly Offered Funds.</u> The definition of a Private Fund contains a specific exception for offshore publicly offered investment funds. Specifically, a Private Fund does not include a company that: (i) has its principal office and place of business outside the United States; (ii) makes, a public offering of its securities in a country outside the United States; and (iii) is regulated as a public investment company under .the laws of a country other than the United States. As a result, an offshore adviser is not required to look through these funds even if they contain investors who are residents of the United States.

2. <u>Application of Advisers Act Requirements.</u> If an SEC-registered offshore adviser advises a U.S. client other, than; through an offshore fund or advises an onshore Private Fund, the adviser will be subject to the full range of Advisers Act requirements. However, if an offshore adviser's only contact with U.S. Clients is that it advises offshore Private Funds that are organized, or incorporated under the laws of a country other than the United States that have 15 or more U.S. clients ("Offshore Private Fund"), the adviser to such Offshore Private Funds ("Offshore Private Fund Adviser") will not be subject to most of the substantive provisions of the Advisers Act.[23]

III. <u>ADVISERS ACT REGULATION OF OFFSHORE PRIVATE FUND ADVISERS</u>

The Offshore Private Fund Adviser will be subject to the following requirements under the Advisers Act: (1) required to register under the Advisers Act; (2) to

[21] When determining if a client is a non-U.S. client, an offshore adviser may look to the following: (1) the residence of a natural person; (2) the principal office and place of business of a corporation or other business entity; (3) the location of the trustee of personal trusts; (4) the location of the executor or administrator of an estate; and (5) the location of the person for whose benefit an account is held in the case of discretionary or non-discretionary accounts managed for another investment adviser.

[22] An investment adviser whose principal office and place of business is in the United States cannot (subject to certain exceptions) register with the SEC unless it has at least $25 million in assets under management and must register with the SEC if it has at least $30 million in assets under management.

[23] Specifically, an Offshore Private Fund Adviser will be required to keep certain books and records and will remain subject to examinations by the SEC staff. However, certain other requirements, such as compliance with the Advisers Act's rules relating to compliance programs, custody of assets, proxy voting, chief compliance officers, codes of ethics, performance fees, ADV delivery, and principal transactions, would not apply to the offshore adviser.

maintain certain books and records required by the Advisers Act; (3) be subject to SEC examinations; (4) required to maintain securities transaction reports of certain employees and (5) will be subject to the Advisers Act Section 206(1) .and 206(2) antifraud rules. Below we discuss each of those requirements:

A. Registration

The compliance date for the new rule and rule amendments is February 1, 2006. By mat date, any hedge fund adviser required to register as a result of the new rule and rule amendments must have its registration effective. An investment adviser registers with, the JSEC by electronically submitting its Form ADV to the SEC. Following submission of properly completed Form ADV, the SEC will notify the investment adviser that its registration has been approved. This will normally occur within 45 days following the submission. As a result, investment advisers should plan on submitting their initial Form ADV to the SEC no later than mid-December 2005.

In addition Investment Advisers are required to complete Form ADV Part II which is designed to inform clients and potential clients about the adviser. Form ADV Part II currently is not filed with the SEC but is maintained by the investment adviser and deemed to be filed with the SEC.

B. Books and Records Requirements

Section 204 of the Advisers Act and Rule 204-2 of the Advisers Act require an investment .adviser registered under the Advisers Act to maintain specific and detailed records pertaining to its business as an investment adviser. Record maintenance is an important obligation of the investment adviser, and SEC staff inspections include a review of the investment adviser’s records. Rule 204-2 permits investment advisers, under certain conditions, to maintain books and records on computer record-keeping devices. Generally, all required records must be kept for five years in an easily accessible place, the first two years in an appropriate office of the adviser. In addition, e-mail and other electronic records relating to the types of records described herein are required to be archived in the same manner as written materials. Offshore Private Fund Advisers that are required to register because they have more than 15 U.S. clients must maintain the following records:

1. A journal and other records of original entry forming the basis of entries in any ledger;

2. General and auxiliary ledgers (or other comparable records) reflecting asset, liability, reserve, capital, income and expense accounts;

3. All checkbooks, bank statements, cancelled checks and cash reconciliations;

4. All bills or statements (or copies thereof) paid or unpaid relating to the adviser's, advisory business;

5. All trial balances, financial statements, and internal audit working papers relating to the business of the adviser;

6. A record of each report made by an access person along with: (i) a record of the names of persons who are currently, or were within the past five years, access persons of the adviser;

7. Records showing separately for each offshore private fund and other offshore client (i) the securities purchased and sold, and the date, amount and price of each such purchase and sale; and (ii) for each security in which any such client or offshore private fund has a current position, information from which the investment adviser can promptly furnish the name of each such client, and the current amount or interest of such client.

8. Corporate records of the adviser, including limited liability and other organizational documents such as articles of incorporation, charters, minute books, and stock certificate books, as may be applicable.

C. Staff Examinations

The SEC's oversight of registered investment advisers includes an inspection program carried out pursuant to the SEC's authority to examine an adviser's books and records under Section 204 of the Advisers Act. As a result of .this inspection authority, the SEC does not need a search warrant to inspect an adviser's required records nor can an adviser challenge their production on the ground of possible self-incrimination.[24] The primary purposes of these inspections are to ensure that: (1) the adviser is in compliance with the Advisers Act and other, applicable federal securities laws; and (2) the adviser's business activities are otherwise consistent with the information disclosed in its Form ADV. The most effective approach for an adviser generally is to cooperate with an SEC inspection to the fullest extent reasonably practicable.

In general, inspections may be divided into three categories: regular, cause, and sweep.

1. "Regular" inspections

The SEC maintains an extensive, regular, on-site inspection program for investment advisers. The SEC staff will generally begin, an inspection by discussing with operations and compliance personnel the firm's control, procedures in the following critical areas that traditionally cause the most enforcement proceedings:

a. • Consistency of portfolio management decisions;

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[24] See Securities and Exchange Commission v. Olsen, 243 F. Supp. 338 (S.D. N.Y. 1965).

b. • Trade order placement (i.e., best execution, etc.);

c. • Allocation of trades; • Personal trading;

d. • Pricing and net asset value calculation;

e. • Reconciliation of custodian and adviser records;

f. • Reconciliation of shareholder transactions;

g. • Information control;

h. • Clients' receipt of information from independent custodians; and

i. • Performance calculations and presentations.[25]

A regular or routine inspection involves a review of the adviser's books and records (to determine that they are accurate, current, and in sufficient detail) and may involve interviewing employees. In addition, regular inspections focus on the adviser's investment activities, and relationships and agreements with clients and affiliates.

2. "Cause" inspections

The SEC may do a "cause" inspection where it believes an investment adviser may be violating the federal securities law. Cause inspections typically arise from client complaints, tips, rumors of trouble, or adverse publicity; calling into question an adviser's business practices and are almost always done on an unannounced basis. Because of the potentially serious nature of a cause examination, an adviser should consider having its legal counsel present or immediately available during the inspection.

The SEC has a Complaint Center on its Web site-to permit investors and others to file complaints with the SEC either electronically or in paper form.

3. "Sweep" inspections

In addition to regular and cause examinations, from time to time the SEC staff will conduct "sweep" inspections, which typically focus on advisers in a particular geographic area or engaged in certain activities. For example, the SEC staff has conducted sweeps inspecting all advisers in a particular location or region (often in conjunction with state examiners). Likewise, the SEC staff has conducted a "soft dollar" sweep, examining the soft dollar and

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[25] See Lori Richards, -Me Evolution of the SEC's Inspection Program. "for Advisers and F ing Apace of a Changing Industry" (speech at conference, Oct. 30, 2002).

brokerage practices of a number of advisers, investment companies, and broker-dealers.

With the growing globalization of investment advisers, the SEC and its corresponding regulators in other countries generally try to coordinate examinations of advisers with global operations. Along with an inspection of the adviser's headquarter office, the various regulators may conduct simultaneous inspections of the adviser's offices in several countries.

4. Results of an SEC inspection

If SEC inspectors find no problems, no action is taken and the SEC staff will likely send the adviser a "no further action" letter within 90 days of the inspection's end. Where SEC inspectors find a violation or a possible violation of the Advisers Act (or other federal securities laws), the SEC staff will generally hold an exit interview with the adviser and discuss the staff's tentative conclusions. Thereafter, the adviser will receive a "deficiency letter" describing the practices or activities in question and the SEC typically seeks to provide the letter within 90 days of the completion of the inspection. A deficiency letter requests that the adviser describe in writing the corrective measures, if any, it has taken in response to the deficiency. Where an adviser disagrees with any alleged deficiency, it may seek to defend its position in the deficiency letter response. Irrespective of the contents of .the response to a deficiency, letter, the adviser should submit a request to the SEC's Freedom of Information Act Officer to keep the response confidential and mark "FOIA Confidential Treatment Requested" on each page of the response. An adviser is typically expected to respond to the deficiency letter within 30 days of receipt.

SEC data show that approximately 89 percent of inspections result in deficiency letters and 4 percent result in enforcement referrals.[26]

D. Disclosure of Conflicts of Interest/ Fiduciary Duties

Under the Advisers Act, an investment adviser is a fiduciary with respect to its clients and has an affirmative duty to act in the best interests of its clients, particularly where there might be a conflict of interest between the investment adviser and its clients. All such conflicts of interest have to be disclosed to the Offshore Private Fund Adviser's clients including investors in Offshore Private Funds.

In addition to the general disclosure obligations, there are specific obligations that the SEC has indicated flow from an investment adviser's fiduciary duty, which include but are not limited to the following: (a) a duty to have a reasonable, independent basis for its investment advice; (b) a duty to seek to obtain best execution for clients' securities transactions where the adviser is in a position to direct brokerage

[26] See SEC, Annual Report (2001).

transactions; (c) a duty to ensure that the advisees investment advice is suitable to the client's objectives, needs and circumstances; and (d) a duty to refrain from effecting personal securities transactions inconsistent with client interests.

E. Access Persons' Personal Securities Reports

1. Advisers Act Rule 204A-1 requires that registered advisers adopt codes of ethics. The codes of ethics must contain certain provisions as described by the rule. Most of the code of ethics requirements do not apply to Offshore Private Funds Advisers. However, Rule 204A-l's requirement that an investment adviser's "access persons" periodically, report their personal securities transactions and holdings to a designated person of the investment adviser does apply to Offshore Private Fund Advisers. These reports include submitting initial and annual holdings reports and quarterly transaction reports disclosing beneficial ownership of reportable securities, subject to specified exceptions.

2. Advisers Act Rule 204A-1 defines an access person as any supervised person of the adviser: (i) who has access, to nonpublic information regarding any clients' purchase or sale of securities, or nonpublic information regarding the portfolio holdings of any reportable fund, or (ii) who is involved in. making securities, recommendations to clients, or who has access to such recommendations that are nonpublic. An access, person also includes all directors, officers and partners of the adviser if the primary business of the adviser involves the providing of investment advice.

3. Section 204 of-the Advisers Act and Advisers Act Rule 204-2 require that SEC-registered investment advisers keep and maintain a record of each report made by an access person.

F. Section 206(1) and 206(2)

Section 206 is the antifraud provision of the Advisers Act. Sections 206(1) and 206(2) generally prohibit an investment adviser from employing a "device, scheme or artifice" to defraud clients or engaging in a "transaction, practice or course of business" that operates as a "fraud or deceit" on clients. While these provisions are often construed together, there are some differences, the most notable being that *scienter* is generally required to find a violation of Section 206(1) while it is not required to find a violation of Section 206(2).[27]

[27] See Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 84 S. Ct. 275, 11 L. Ed. 2d 237 (1963); In re Michael L. Smirloek, Investment Advisers Act Release No. 1393 n.4 (Nov.

Among the many types of activities that have been found or alleged to violate Sections 206(1) or 206(2) are: misrepresenting pricing methodology or failing to follow disclosed valuation methods[28], deliberate mispricing of portfolio holdings or manipulating market prices to inflate valuations[29], misrepresenting internal controls, miscoding, forging or failing to submit order tickets, overstating performance results[32], purchasing securities in contravention of prospectus disclosure, favoring certain clients or proprietary accounts in allocating initial public offerings or other trades, without adequately disclosing this practice[34], taking advantage of investment opportunities belonging to the client or fund[35], undisclosed commission-splitting, arrangements,[36] failing to disclose soft dollar or other brokerage practices, failing to disclose personal financial interest in securities transactions for clients or

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29, 1993); in re Kingsley, Jennison, McNulty & Morse, Inc., et al., Admin. Proc. File No. 3-7446 *(Nov.* 14, 1991); and Investment Advisers Act Release No. 1396 (Dec. 23, 1993).

[28] See In re Askin Capital and David J. Askin, Investment Advisers Act Release No, 1492, 1995 WL 312520 (May 23, 1995); SEC v. Michael L. Smirlock, et al., Litigation Release. No. 16838 (Dec. 21, 2000); In re Stephen H. Brown, Investment Advisers Act Release No. 1751, 1998 WL 603224 (Sept 14, 1998).

[29] See In re Van Kanipen American Capital Mgmt, Inc., Investment Advisers Act Release No. 1525, 1995 WL 579533 (Sept. 29,1995); In re Andrew S. Partin, Investment Advisers Act Release No. 1967 (Aug. 10, 2001); SEC v. Burton G.-Friedlander,. et al., Litigation Release No. 17021 (June 1, 2001).

[30] See In re First Capital Strategists, et at, Investment Advisers Act Release No. 1648,1997 WL 458704 (Aug. 13, 1997).

[31] See In re Scudder Kemper Investments, Inc., et al., Investment Advisers Act Release No. 1848 (Dec. 22, 1999); In re Michael T. Sullivan, III, Investment Advisers Act Release No. 1849 (Dec. 22, 1999).

[32] See, e.g., SEC v. DynamicDaytrader.com LLC, et al., Litigation Release No. 16475: (Mar, 20,2000); In re First Capital Strategists, et al., Investment Advisers Act Release No. 1648,1997 WL 458704 (Aug. 13, 1997).

[33] See In re Stephen H. Brown, Investment Advisers Act Release No. 1751, 1998 WL 603224 (Sept 14, 1998); In re Mitchell Hutchins Asset Mgmt., Inc., Investment Advisers Act Release No. 1654, 1997 WL 537042 (Sept. 2, 1997).

[34] See, e.g., SEC v. Alan Brian Bond, et at, Litigation Release No. 17099 (Aug. 10, 2001); SEC v. Timothy J. Lyons, Investment Advisers Act Release No. 1882 (June 20, 2000); In re Monetta Financial Services, Inc., et al., Admin. Proc. File No. 3-9546 (Mar. 27, 2000); In re The Dreyfus Corporation, et al., Investment Advisers Act Release No. 1870 (May 10, 2000); In re F.W. Thompson Company, Ltd., et at, Investment Advisers Act Release No. 1895 (Sept. 7, 2000); In re McKenzie Walker Investment Mgmt., Inc., et al. Investment Advisers Act Release No. 1571, 1996 WL 396091 (July 16, 1996); In re Account Mgmt. Corp., et al., Investment Advisers Act Release No. 1529, 1995 WL 579449 (Sept. 29, 1995); In re John Giura, et al., Investment Advisers Act Release No. 1095, 1987 WL 113797 (Nov. 13, 1987); In re Shearson Lehman Brothers, Inc., et al., Investment Advisers Act Release No. 1038, 1986 WL 73253 (Sept. 24,1986).

[35] See In re Schwendiman Partners, LLC, Investment Advisers Act Release No. 2043, WL 1484401 (2002); In re Kemper Financial Services, Inc., et al., Investment Advisers Act Release No. 1494, 1995 WL 358116 (June 6, 1995); In re Joan Conan, Investment Advisers Act Release No. 1446, 1994 WL 549000 (Sept. 30, 1994); In re Ronald V. Speaker, et al., Investment Advisers Act Release No. 1605, 1997 WL 9871 (Jan. 13, 1997).

[36] See In re Thomas J. Bowne, Investment Advisers Act Release No. 1468, 1995 WL 65390 (Feb. 10, 1995); In re Capital Markets Research Co. & Paul Edward Holl, Investment Advisers Act Release No. 1834, 1999 WL 756073 (Sept. 27, 1999).

[37] See, e.g., In re Dawson-Samberg Capital Mgmt, Inc., et al., Investment Advisers Act Release No. J:889 (Aug. 3, 2000); In re Oakwood Counselors, Inc. et al., Investment Advisers Act Release. No. 1614, 1997 WL

related conflicts of interest[38], misusing and diverting funds under management[39], failure to disclose "double fees" received from clients'assets invested in a fund advised by the adviser[40], interpositioning" a broker between a fund or client and dealers making a primary market in securities, thereby causing the fund or client to incur unnecessary expenses[41], failing to disclose to clients that the prices obtained for them were not the most favorable under the circumstances[42], failing to seek best execution on client transaction[43], failing to disclose that client commissions were used to compensate brokers for client referrals;[44] and undisclosed bribery or "kickback" schemes.[45]

Among the most important requirements of Sections 206(1) and 206(2) is the necessity of making full and adequate disclosure to clients regarding various matters that may have an impact on the investment adviser's independence and judgment. Most important, conflicts of interest have traditionally been a source of concern in the regulation of investment advisers because of the position of trust and confidence an adviser assumes with respect to its clients. Thus, the Advisers Act and particularly Section 206 was intended to bring such conflicts of interest to the attention of clients to permit fully informed decisions regarding the adviser. While the amount and nature of the disclosure required depend on the facts and circumstances of each case, the duty of disclosure in situations involving a potential conflict of interest has generally been construed to be broader

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54805 (Feb. 10, 1997); In re Marvin & Palmer Associates, et al., Investment Advisers Act Release No. 1841, 1999.WL 777443 (Sept. 30; 1999).

38 See SEC v. Thomas E. Loyd, et al., Litigation Release No. 16495 (Mar. 31,2000); SEC v. Yun Soo Oh Park, et al., Litigation Release No. 16399, (Jan. 5,2000); In re John J. Kaweske, Investment Advisers Act Release No. 1539; 1995 WL 699197 (Nov. 27, 1995); In re Roger W, Honour, Investment Advisers Act Release No. 1527, 1995 WL 579.523 (Sept. 29, 1995). See also In re Chancellor Capital Mgmt., Inc, et al., investment Advisers Act Release No. 1447, 1994 WL 570098 (Oct. 18, 1994).

39 See In re Don A. Long, Investment Advisers Act Release No. 779, 1981 WL 37852 (Oct. 6, 1981)

40 See In re Thomson McKinnon Asset Mgmt., L.P., Investment Advisers Act Release No. 1243, 1990 WL 321517 (July26, 1990).

41 See, In re Portfolio Advisory Services, LLC, Investment Advisers Act Release No. 2038, 2002 WL 1343823 (June 20, 2002); In re Edgemont Asset Mgmt. Corp. and Bowling Green Securities, Inc., Investment Advisers Act Release No. 1284, 1991 WL 286764 (June 18, 1991); In re Synovus Securities, Inc., et al., Investment Advisers Act Release No. 1423 (July 5, 1994).

42 See In re Portfolio Mgmt. Consultants, Inc., Investment Advisers Act Release No. 1568, 1996 WL 354415; (June 27, 1996);

43 See In re Fleet Investment Advisors Inc., Investment Advisers Act Release No. 1821, 1999 WL 695211 (Sept. 9, 1999); In re Karen Michalski & Christopher D. Sargent, Investment Advisers Act Release No. 1822, 1999 WL 695212 (Sept. 9, 1999)

44 In re Portfolio Advisory Services, LLC Investment Advisers Act Release No. 2038, 2002 WL 1343823 (June 20, 2002); In re Duff & Phelps Investment Mgmt. Co., Inc., Investment Advisers Act Release No. 1984 (Sept. 28, 2001); In re Founders Asset Management LLC, et al., Investment Advisers Act Release No. 1879 (June 15, 2000); In re Fleet Investment Advisors Inc., Investment Advisers Act Release No. 1821, 1999 WL 695211 (Sept. 9, 1999).

45 See SEC v. Paul J. Silvester, et al., Litigation Release No. 16759 (Oct. 10, 2000); In re William A Stephens, Admin. Proc. File No. 3-10231 (June 14, 2000).

than under normal circumstances (i.e., more extensive and detailed disclosures are required).

RECENT ENFORCEMENT ACTIONS.

I. INTRODUCTION.

Since the near collapse of the once-heralded Long-Term Capital, Ltd. hedge fund[46] and the successful securities fraud case brought against Michael Berger and the Manhattan Investment Fund, Ltd.,[47] the SEC has been taking an increasingly active role in enforcing the applicable securities laws as they apply to hedge, venture, and other private funds and the principals who manage them. This summary will explore and analyze the SEC's recent enforcement actions against such funds and their advisers and will categorize, and summarize these actions by the type of violation(s) charged.[48]

The SEC's recent enforcement activity in the private funds area has focused .on four basic allegations giving rise to securities law violations: false and misleading statements regarding the fund's performance or risk; misappropriation of investors' funds; engaging in general advertising or solicitation; and manipulation of the fund's underlying investments. The SEC has also brought charges against investment advisers of private funds for recordkeeping violations for acting as unregistered investment advisers. Each of these will be discussed more fully below.

II FALSE AND MISLEADING STATEMENTS.

By far the greatest number of enforcement actions brought by the SEC against private funds involve allegations of fraud resulting from false and misleading statements about a fund's performance, value, risk profile, or the performance of the investment manager advising the fund. The SEC's focus has been not only on fraudulent statements made in connection with the solicitation or offering of fund interests, but also on fraudulent statements made in account statements sent to investors after their initial investment.

Many of the enforcement actions brought by the SEC have alleged material misstatements or omissions in the offering materials used to obtain new investors.

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[46] See, e.g., Lakonia Mgmt, Ltd. v. Meriwether, 106 F. Supp. 2d 540 (S.D.N.Y. 2000).

[47] See, e.g., United States v. Berger, 188 F. Supp. 2d 307 (S.D.N.Y. 2002); SEC v. Berger, et al., 244 F. Supp. 2d 180(S.D.N.Y. 2001); *In the Matter of Fin. Asset Mgmt., Inc*., Securities Act Rel. No. 8052, 2002 SEC LEXIS 8 (Jan. 3, 2002).

[48] For more recent SEC enforcement actions, see SEC v. Silverman, Litig. Rel. No. 18597, 2004 SEC LEXIS 441 (Feb. 25, 2004); SBC v. BPG Global Private Equity Fund et al., Litig. Rel. No. 18577, 2004 LEXIS 327 (Feb. 17, 2004); SEC v. Millennium Capital Hedge Fund, L.P., Litig. Rel. No. 18481, 2003 LEXIS 2853; *In the Matter of David M. Mobley*, Advisers, Act Rel. No. 2131, 2003 SEC LEXIS 1220 (May 20,2003)

For example, in SEC v. Platinum Investment Corp., et al.,[49] the SEC brought securities fraud charges against a registered broker-dealer and its principals for making material misrepresentations in two unregistered stock offerings, one of which was a purported hedge fund. The SEC alleged that the principals of Platinum Investment Corporation made false and misleading statements portraying New Focus Capital Partners as a domestic hedge fund with a successful track record and, as a result, obtained over $1.5 million from at least 56 investors. The complaint seeks permanent injunctions against all principals, as well as disgorgement and civil penalties. The U.S. District Court for the Southern District of New York has granted a preliminary injunction and froze the defendants' assets pending resolution of .the suit.

The SEC has also brought securities fraud, charges against a. hedge fund and its principals for making false and misleading statements, in offering materials and on the hedge fund's web site. In SEC v. Ryan J. Fontaine,[50] the SEC brought an enforcement action against a purported hedge fund and its principal alleging that the fund made an unregistered offering of securities over the Internet; and, in addition, made numerous false claims about the fund's track record amount of assets under management, and affiliations with well-known financial institutions. The complaint, brought in the U.S. District Court for the Southern District of New York, alleges that, between July and October 2002, Fontaine deceived investors by fraudulently claiming, among other things, that: (a) the fund's average annual return was 39.5% over a 13-year history; (b) the fund had approximately $250 million under management; (c) Salomon Smith Barney was a sub-adviser to the fund; and (d) KPMG performed certain auditing services for the fund. A final judgment against Fontaine and Simpleton Holdings Corporation (also known, as Signature Investments Hedge Fund) was entered by the U.S. District Court for the Southern District of New York permanently enjoining them from violating the anti-fraud and registration provisions, and ordering them, to pay $29,837 in disgorgement and prejudgment interest and a $29,300 civil penalty.[51]

In SEC v. House Asset Management, L.L.C. et al.,[52] the SEC alleged that the defendants solicited potential investors to invest their retirement savings in House Edge, L.P., a hedge fund, by making material misrepresentations about the fund's return. The complaint alleged that the defendants told investors that the hedge fund had generated cumulative returns of 148% since its inception by engaging in a sophisticated securities trading strategy, when in fact the fund had suffered losses of more than $850,000 since its inception. The defendants raised approximately $2.9 million from at least 60 investors between March 2000 and June 2002. The complaint also alleged that the defendants made false and misleading statements about the principals' investment

49 Litig. Rel. No. 17679, 2002 SEC LEXIS 2083 (Aug. 14, 2002). *See also SEC v. Platinum Inv. Corp., et al.*, Litig. Rel. No. 18064, 2003 SEC LEXIS 779 (Apr. 2, 2003); SEC *v. Platinum Investment Corp., et al*., Litig. Rel. No. 17643, 2002 SEC LEXIS 1956 (July 31, 2002).

50 Litig. Rel. No. 17864, 2002 SEC LEXIS 3031 (Nov. 26,2002).

51 Litig. Rel. No. 18254, 2003 SEC LEXIS 1773 (July 28, 2003).

52 Litig. Rel. No. 17583, 2002 SEC LEXIS 1610 (June 24, 2002).

experience and background and did not disclose that one of the principals was terminated as a registered representative for unauthorized sales of hedge fund shares and was barred by the NASD. The SEC obtained an order of permanent injunction from the U.S. District Court for the Central District of Illinois enjoining the defendants from violating the antifraud provisions of the securities laws and freezing the assets of the defendants. In February 2003, the SEC agreed to settle the action, imposing the sanction whereby the defendants are barred from association with any investment adviser.[53]

In addition to making misstatements in solicitation and offering materials, many private funds have been subject to SEC enforcement actions for making false and misleading statements in continuing communications to shareholders. In SEC v. Beacon Hill Asset Management, LLC, [54] the SEC obtained a preliminary injunction against the manager of a group of hedge funds for materially misstating net asset values and corresponding returns to the funds' investors. Among other violations, the hedge fund manager reported that the funds' losses were estimated to be 25%, when the actual losses were approximately 54%, including losses that had not been reported in prior reporting periods. The Commission's investigation into Beacon Hill Asset Management is continuing.

In Edward Thomas Jung and E. Thomas Jung Partners, Ltd.,[55] the SEC filed a civil complaint in the U.S. District Court for the Northern District of Illinois against the manager of a private, unregistered hedge fund for fraudulent statements made both in offering materials and also in quarterly account statements sent to investors in the fond. The SEC's complaint alleged that between 1994 and 1998, the fund and its manager were responsible for issuing a series of false performance reports that materially overstated the fund's and the manager's prior trading record and falsely stated that-investor, assets would be used solely to conduct the fund's business and to collateralize trading on behalf of the fund. In fact, the complaint alleged that the manager placed the fund's assets in its own account and used them to collateralize the principal's own .personal margin trading, which resulted in a loss of more than $21 million for *55* investors. To conceal this loss, the manager sent false quarterly account statements to the fund's investors that materially overstated the current value of their investment. In February 2003, criminal charges were filed against Jung and in February 2004, a criminal jury found him guilty of eight counts of wire fraud and two counts of securities fraud.[56]

53 *In the Matter of Paul J. House, et al.*, Advisers Act Rel. No. 2108,2003 SEC LEXIS 330 (Feb. 6,2003).

54 Litig. Rel. No. 2912, 2002 SEC LEXIS 2912 (Nov. 15, 2002).

55 Exchange Act Rel. No. 45669, 2002 SEC LEXIS 793 (March 28, 2002). *See also United States of America v. Jung*, Litig. Rel. No. 17995, 2003 SEC LEXIS 439 (Feb. 25, 2003) (the United States Attorney for the Northern District of Illinois filed criminal charges against Jung on February 18, 2003); SEC *v. Jung, et al.*, Litig. Rel. No. 17417, 2002 SEC LEXIS 596 (March 15, 2002); SEC *v. Jung, et al.*, Litig. Rel. No. 17041, 2001 SEC LEXIS 1185 (June 20, 2001).

56 Litig. Rel. No. 18570, 2004 SEC LEXIS 273 (Feb. 9, 2004). See also, United States of America v. Edward Thomas Jung (N. D. III.), Case No. 03-CR-172.

In SEC v. Jean Pierre, et al.,[57] the SEC brought suit against two brokers and a college professor in connection with the fraudulent offering of LP interests in JB Stanley, a hedge fund. The complaint charged the defendants with making, false and misleading statements, both orally and in the fund's offering materials, concerning the investment strategy of the fund, the fund's business history and prospects, and one-of the brokers' past performance. The complaint also alleged that most of the offering proceeds were misappropriated to pay for the brokers' personal expenses. In order to induce investors to maintain their investments in the fund, the defendants also distributed false account statements that materially misrepresented the fund's performance. The charges brought by the SEC included violations of Sections 5(a), 5(c), and 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Sections 206(1) and 206(2) of the Advisers Act The. U.S. District Court for the Southern District of New York granted summary judgment to the SEC and permanently, enjoined the brokers from future violations of the above antifraud provisions of the federal securities laws. In addition, the court ordered that they disgorge all ill-gotten gains and pay the civil penalties pursuant to Section 308 of the Sarbanes-Oxley Act of 2002.

There does not appear to be a minimum investment amount or number of investors to trigger enforcement action by the SEC. For example, the SEC brought an enforcement action against a hedge fund and its principal alleging that for a period of two months, the fund made false and misleading statements about the safety and return investors could expect from an investment in the hedge fund.[58] These statements were made in a series of solicitation letters and e-mails to clients of the principal's broker-dealer and through the broker-dealer's web site. These communications, which raised $10,000 from a single investor, described the hedge fund as a safe, government-sponsored investment vehicle that would yield returns of 15% to 50%. In response to an inquiry from the SEC Staff, the hedge fund offering was terminated and the investor's assets were returned. The principal and the fund were ordered to cease-and-desist from committing or causing any future violations of securities laws, were barred permanently from any association with any broker or dealer and ordered to pay a civil penalty.[59]

The SEC has also brought actions against investment advisers to hedge funds for their role in providing misleading performance reports to investors. In Charles K. Seavey,[60] the SEC found that Morgan Fuller Capital Management and its employee, Charles Seavey, violated Sections 206(1) and 206(2) of the Advisers

57 *SEC v. Jean Pierre, et al*., 2003 U.S. Dist. LEXIS 10933 (SD.N.Y. 2003), Fed. Sec. L. Rep. (CCH) ¶92,448 (June 27, 2003); Litig. Rel. No. 18045, 2003 SEC LEXIS 675 (March 21, 2003); Litig. Rel. No. 17303, 2002 SEC LEXIS 59 (Jan. 10, 2002).

58 *See John Christopher McCamey and Sierra Equity Partners, LP*, 1933 Act Rel. No. 8137, 2002 SEC LEXIS 2567 (Oct. 8, 2002).

59 See *In the Matter of John Christopher McCamey and Sierra Equity Partners LP,* 1933 Act Rel. No.8254, 2003 SEC LEXIS 1680 (July 18, 2003).

60 Adm. Proc. No. 3-10336, 2003 SEC LEXIS 716 (Mar. 27, 2003). *See also Charles K. Seavey and Alexander Lushtak*, Advisers Act Rel. No. 1925A, 2001 SEC LEXIS 501 (March 9, 2001); *Charles K. Seavey and Alexander Lushtak*, Advisers Act Rel.; No. 1925, 2001 SEC LEXIS 305 (Feb. 20, 2001).

Act by making material misstatements and omissions in letters and performance reports sent to investors in the Paradigm Capital Fund, a hedge fund, regarding the stock of a Lithuanian bank. The performance report reflected the fund's investment in the bank's stock despite the fact that the purchase transaction had never settled and the fund did not in fact own the shares. The inclusion of the bank stock in the performance report caused the fund's performance to appear much more favorable than it actually was. The SEC imposed a temporary censure, suspension and cease-and-desist order on Seavey for his role in preparing and distributing the performance report, as well as a $ 10,000 second-tier fine.

In SEC v. Hoover and Hoover Capital Management, Inc.,[61] the SEC filed a securities fraud complaint in the U.S. District Court for the District of Massachusetts alleging that Stevin Hoover, a registered investment adviser, solicited and obtained investments in the Chestnut Fund, L.P., a domestic hedge fund, by making fraudulent misrepresentations to prospective investors, both orally and in writing in the fund's private placement memorandum. The SEC further alleged that, during .an 18-month period after establishing the fund, Hoover misappropriated more than $625,000, used these funds for personal and business expenses, and concealed the misappropriation by distributing fictitious account statements to investors.[62] Hoover pled guilty to one count; of securities fraud. In February 2003, without admitting or denying the SEC's allegations of misrepresentation, misappropriations and fictitious account statements, Hoover consented to a final judgment ordering him and his entities to pay over $1 million hi disgorgement and prejudgment interest.[63]

In Michael Smirlock,[64] the SEC brought civil charges against a registered .investment adviser for falsely increasing the value of ah investment portfolio he managed for three hedge funds in order to induce additional investors to invest. The complaint alleged, among other things, that, between December 1997 and June 1998, the adviser engaged hi securities fraud by inflating the values reported for thinly traded securities known as swaptions. The adviser settled the SEC's action by agreeing to the entry of a final judgment that permanently enjoins him from further violations of the securities laws and permanently bars him from association with an investment adviser.[65] In a criminal case filed simultaneously with the SEC's civil

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61 Litig. Rel. No. 17666, 2002 SEC LEXIS 2045 (Aug. 8, 2002). See also SEC v. Hoover, et al., Litig. Rel. No. 17825, 2002 SEC LEXIS 2797 (Nov. 1, 2002) (in a criminal case, Hoover was sentenced to 18 months imprisonment, followed by three years of supervised release during which Hoover will be barred from providing any financial services or acting as the custodian for funds belonging to other people); In the Matter of Stevin R. Hoover, et al., Advisers Act Rel. No. 2068, 2002 SEC LEXIS 2681 (Oct. 21, 2002); SEC v. Hoover, et al., Litig. Rel. No. 17487, 2002 SEC LEXIS 1067 (April 24, 2002); SEC v. Hoover, et al., Litig. Rel. No. 17284, 2001 SEC LEXIS 2618 (Dec. 19, 2001).

62 The SEC's complaint alleges generally that Hoover misappropriated nearly S3 million from clients of his management firm, Hoover Capital Management, Inc., including investors in the hedge fund. Id Enforcement actions alleging misappropriation of investment funds are discussed separately below.

63 SEC v. Hoover, Litig. Rel. No. 17981, 2003 SEC LEXIS 354 (Feb. 11, 2003).

64 Investment Company Act Rel. No. 2046, 2002 SEC LEXIS 2061 (Aug. 12, 2002). See also United States v. Smirlock, Litig. Rel. No. 17536, 2002 SEC LEXIS 1381 (May 28, 2002).

65 SEC v. Smirlock, et al., Litig. Rel. No. 17630, 2002 SEC LEXIS 1889 (July 24, 2002).

action, the adviser pled guilty to two counts of securities fraud and was sentenced to four years incarceration and ordered to pay $ 12.6 million in restitution. .

III. MISAPPROPRIATION OF INVESTOR FUNDS.

In addition to false and misleading statements made to induce and maintain investors in private funds, the SEC has also focused, on the funds' use of investor assets. A number of actions have recently been brought by the SEC against private funds and, more frequently, against the individuals operating such funds, for misappropriation of investors' assets. The SEC generally takes the view that any investor funds that are used in a manner inconsistent with that disclosed in the offering material can be deemed misappropriated.

In SEC v. Chabot, et al.,[66] the court entered a judgment against Peter Chabot for securities fraud. The SEC brought securities fraud charges against Sirens Synergy, an offshore hedge fund, and Chabot, its manager alleging that Chabot misappropriated more than $1.2 million in investor funds. The complaint alleged that Chabot, individually and through his broker-dealer and adviser Entities, raised over $L2 million from approximately 14 investors by making false and misleading statements concerning the fund's investment strategy. Chabot claimed that he was an experienced trader who had developed a mathematical model to predict when to buy stocks and whether-to take long or-short positions; The complaint alleged that Chabot never bought securities with; the investors' funds, but instead used those assets on consumer goods and services, including computers, clothes, travel tickets to prestigious sporting events, furniture, oriental rugs, and jewelry. In addition, the complaint alleged that Chabot made over 130 ATM withdrawals totaling $60,000 from a bank account that contained investor funds. The SEC obtained a preliminary injunction enjoining Chabot and his entities from further violations of the securities laws and freezing their assets pending resolution of the litigation, and the United States District Court for the Southern District of New York entered a final judgment against Chabot.

Misappropriation of investor funds for uses other than personal expenses has also been a focus of the SEC. In SEC v. House Asset Management, L.L.C., et al.,[67] the SEC alleged that the defendants misappropriated investor funds in part because they borrowed funds from the hedge fund to purchase an office building for the fund's adviser. Similarly, in SEC v. Hoover, etal.,[68] the SEC charged that the investment adviser of a hedge fund misappropriated fund assets to pay, among other things,

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[66] Litig. Rel. No. 17276, 2001 SEC LEXIS 2603 (Dec. 17, 2001). See Litig. Rel. No. 18214, 2003 SEC LEXIS 1572 (July 3, 2003). See also SEC Charges Offshore Hedge Fund and Its 26 Year Old Manager with Fraud, Obtains Emergency Relief, SEC News Digest 2001-218,2001 WL 1420610 (S.E.C.) (Nov. 13,2001).

[67] Litig. Rel. No. 17583, 2002 SEC LEXIS 1610 (June 24, 2002).

[68] Litig. Rel. No. 17666, 2002 SEC LEXIS 2045 (Aug. 8,2002). See also SEC v. Hoover, et al., Litig. Rel. No. 17487,2002 SEC LEXIS 1067 (April 24, 2002); SEC v. Hoover, et al., Litig. Rel. No. 17284, 2001 SEC LEXIS 2618 (Dec. 19, 2001).

office rent and repayments to former clients who were victims of an earlier securities fraud.

The SEC has also alleged misappropriation in instances where a fund's manager has failed to invest in a manner consistent with that described in the offering materials. For example, in Brian Prendergast,[69] the SEC upheld disciplinary actions taken by the NASD against a hedge fund manager for, among other things, misappropriating investor funds. The fund's private placement memorandum described an investment allocation of 60% in S&P stock index futures and 40% in load and no-load mutual funds. Instead of following this allocation, the SEC charged that the manager began investing in vehicles other than those identified in toe private placement memorandum, including Chicago Board of Trade Treasury Bond futures and foreign currency options. No mutual fund shares were ever purchased. The manager was censured and barred from association with any NASD member in any capacity.

A number of the misappropriation actions brought by the SEC involve a Ponzi scheme disguised as a hedge or other private fund. For example, the SEC brought a civil action against Paramount Financial Partners, L.P., a hedge fund, and its principals for securities fraud in connection with the offering *of* partnership interests.[70] The complaint alleged that, from May 2000 through March 2001, the defendants raised over $15 million from investors by portraying Paramount- as a registered hedge fund that generated returns of as much as 99%. The defendants told investors that Paramount had access to certain discounted securities that it could purchase and re-sell at a substantial profit. The defendants also told investors that they were required to maintain their principal and interest with Paramount for a set period of time. The complaint alleged mat investor proceeds were not used to buy securities, but rather were used to-pay earlier investors and to pay personal .and business expenses. The, SEC obtained a preliminary injunction enjoining Paramount and its principals from selling securities or accepting additional funds from investors. The injunction also enjoined the defendants from committing further securities law violations and directed that they provide sworn accountings to the SEC to account for investor funds.

In SEC v. Vestron Financial Corp., et al.,[71] the SEC brought a civil complaint against the operators of two hedge funds alleging that the defendants misappropriated more than $2 million of investor funds and engaged in a Ponzi scheme by paying off earlier investors with new investor proceeds. The complaint alleged that the defendants raised more than $11.6 million from over 350 investors by promising high returns from stock and commodities trading in both a U.S. and an offshore hedge fund. The SEC charged that, of that

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69 Exchange Act Rel. No. 44632, 2001 SEC LEXIS 1533 (Aug. 1, 2001).

70 SEC v. Cummings, et al., Litig. Rel. No. 17840, 2002 SEC LEXIS 2940. See SEC v. Cummings, et al., Litig. Rel. No, 17598, 2002 SEC LEXIS 1720 (July 3, 2002). See also SEC v. Cummings, et al., Litig. Rel. No. LR 17581, 2002 SEC LEXIS 1603 (June 24, 2002).

71 Litig. Rel. No. 17200, 2001 SEC LEXIS 2209 (Oct. 22, 2001).. See also SEC v. Vestron Financial Corp., et al., Litig. Rel. No. 17433, 2002 SEC LEXIS 759 (Mar. 27,2002).

$11.6 million, only 14% was used for actual trading. The funds' operators used the remaining investor funds to purchase condominiums, boats, cars, and other personal items. In addition, the SEC alleged that the defendants were conducting a Ponzi scheme whereby investors who chose to receive their purported monthly gains in cash were paid out of new investor funds. The U.S. District Court for the Southern District of Florida enjoined the operator of funds from future violations of the federal securities laws.[72] In addition, the SEC imposed a sanction barring the defendant from association with any broker, dealer, or investment adviser, pursuant to Section 15(b) of the Exchange Act and Section 203(f) of the Advisers Act.[73]

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72 In the Matter of Salman Shariff, Exchange Act Rel. No. 47145; Advisers Act Rel. No. 2096, 2003 SEC LEXIS 54 (Jan. 9, 2003); see also SEC v. Vestron Financial Corp., et al., Litig. Rel. No. 18065, 2003 SEC LEXIS 780 (Apr. 2,2003) (the United States Attorney for the Southern District of Florida indicted Salman Shariff, the operator of the funds, and charged him with ten counts of mail fraud, seven counts of wire fraud, seven counis of securities fraud, and nineteen counts of money laundering).

73 Id.