

Statutes, Rules, and Related Cases

Investment Company Act of 1940 Exemptions:

- **3c1** (100 investor limit and non-public offering) (corp may only count as 1)
 - **3c1(a)** – if investor-company holds 10% or more of fund’s securities, then look through to individual investors
 - SEC Staff: If offshore fund may exclude foreign investors for purposes of 3c1 limit
 - note: b/c of Reg. D, all but 35 need to be Accredited Investors
 - 3c5--Do not count K.E.’s for 3c1 limit
- **3c7** (QPs & non-public offering) (QP = individual w/ 5 M invstmnts, company 25M invstmnts)
 - Investments: assets held for inv. purposes. INCLUDE cash, retirement accounts, etc. EXCLUDE: personal residence, RE used in bus. (unless RE bus.). IGNORE: debt OK.
 - Measure QP at time of investment
 - 3c5—K.E.’s do not need to be QPs for 3c7 fund
 - SEC staff: *offshore* fund relying on 3c7 for U.S. investors not subject to QP reqs w/r/t *foreign* investors
 - *H.G. Butts*: Pension Plan can be single QP if manager makes all decisions (if individual contributors decide then look through to them)
 - *Standish Ayer*: If 401(k) allows choices about particular Pfunds to invest, each investor needs to be QP (BUT if give menu of broad options butnot particular funds, one QP)
 - *Shoreline*: Parallel funds won’t be integrated if are for different tax treatments (thus appeal to different groups). Gen. Rule--whether funds would be viewed by reas. investor as mat. different.
 - *Frontier*: Funds should be integrated b/c: similar objectives, similar securities; SAME INVESTORS
- **3c5** (knowledgeable employees)—(look to whether was K.E. *at time of investment*)
 - 1. Director, Executive, trustee, GPs, advisory board members, unit/function head
 - 2. Employee who in connection with job functions participates in investment activities
 - ABA Letter: SEC says look to whether participated in *investment decision*
 - (IR, no; Analyst, yes; Research Analysts: probably yes; Trader, No; accounting, No; GC, NO unless exec w/ say)
- **§48 – unlawful** to create feeder structure to circumvent law (if do, look through & count indiv. investors)
 - *Cornish & Carey*: SEC says if <40% of an entity’s investment in 1 PF, usually SEC finds not formed to circumvent law. But 40% not necessary/sufficient b/c not statutory req. Here, plan couldn’t represent <40% in certain 3c1 fund & SEC said could still be OK—depends on “facts and circumstances.” Company claims here purpose to reward employees.

33 Act

- **§4(2)** – Exempts transactions not involving a public offer from registration
 - **Reg D** is a safe harbor under 4(2), but not the only way to be exempted
 - (summary of safe harbor: unlimited AIs, ≤35 non-accredited, & non-public offering)**Rule 506(b)** – must comply with Rules 501 and 502
 - 506(b)(2)(i) **35 Investors Max** (Accredited Investors don't count see 501(e))
 - **Rule 501(a)**
 - individual AI=net worth (indiv/joint)>\$1M, OR income >\$200k (or \$300k joint) last 2 years and reasonable expectation this year, OR director, officer, or GP of adviser or fund
 - entity AI=banks and savings & loan, OR B/D, OR corps/trusts/plans/p-ships >\$5M assets
 - NOTE: QP's will always meet AI reqs so AI becomes issue only for 3c1
 - 506(b)(3)(ii) non accredited investors must have sufficient experience and knowledge in financial and business matters to evaluate the risk
 - **Rule 502 (c)** No general solicitation or general advertising,
 - No advertisement, article, notice or communication in newspaper, magazine or similar media broadcast over television or Radio AND
 - No seminars whose attendees were invited in similar matter (Good faith publication of Form D not an advertisement, items written by journalist from OFFSHORE press releases or press conferences are not an advertisement)
 - SEC Guidance: Must Have **Preexisting Relationship**
- **§5** –
 - **rule: if req'd to be registered**, unlawful to sell securities before reg. in effect in interstate commerce
 - can't short a PIPE or use a PIPE to close out a short position
- **§17a** – Unlawful **in offer or sale of any security**, by use of instruments of interstate communication or transportation in **interstate commerce**
 - 1. Employ device, scheme, or artifice to defraud, OR
 - 2. Obtain money or property by untrue statements of **material facts** or material omission, OR
 - 3. To engage in any transaction, practice, or course of business that operates as **fraud** or deceit
 - NEGLIGENCE STANDARD (SEC v. Fife) (also no reliance needed for fraud)
- Fraud cases:
 - *Fife*: starts fund and just steals the money, transfers it to own account (17a requires only negligence) 10b5 requires scienter, court says they have scienter. Also section 206 violated.

- They lied and defrauded investors
 - *Northshore/Ardent* – bought an advisor so they could manage Ardent fund, ripped off Ardent fund by “investing” in their own companies
 - Failed to disclose material fact of change of control of advisor; deceived by not investing how they said they would
- **Secondary Resales (under '33):** Private funds relying on Rule 506 must exercise reasonable care to assure their investors are not investing w/ view to distribute to public.
 - unrestricted resales to public jeopardizes exemption of the entire private offering.
- **Reg. S (Under §5):** If totally offshore, then considered a private placement (don't need to worry about Registering under 33 Act or complying with Reg. D if totally offshore as outlined in Reg. S)
 - Offer is Offshore, No directed selling efforts in the US, foreign investor
 - Can satisfy Reg S and still have your decision maker (adviser) onshore

Exchange Act of 34

- **§9(a)(4)** - market manipulation – by use of interstate commerce, related to sale of security, made statements that were false or misleading respecting material fact to induce the purchase of a security
 - Knew or had reasonable ground to believe were false
- **§10** – Unlawful to use interstate commerce, the mails, or any security exchange to
 - **b** – in connection with purchase or sale of any security, use manipulative or deceptive practice
- **Rule 10b(5)** – unlawful by use of interstate commerce, mails, or nat'l security exchange
 - Employ a device, scheme or artifice to defraud
 - Make any untrue statements of material facts or material omission
 - Engage in any practice, act, or course of business that would operate as fraud or deceit
 - **SCIENTER** – Knowing/Intent or High Degree of Recklessness (*Sec v. Fife*)
 - **INSIDER TRADING:** 1. Material non-public information, 2. Some trade of security, 3. Some duty violated
 - Mark Cuban – was told info and person who told him said not to trade on it, gov't says should be a breach of duty, Cuban says no duty, Cuban won in dist. Now at 5th Cir.
 - O'Hagen – have duty to your firm that is representing acquirer not to buy target stock (misappropriation)
 - Heard on the Street – WSJ writer – trading ahead of his columns, misappropriation of info from Journal
 - Berliner--when you open your mouth to speak re: a security, maybe at that moment you have duty to not misstate/omit (see Berliner—otherwise, who did Berliner have duty to?)

- **Rule 12g-1:** < 499 investors per fund maximum or you have to register under 34 Act
- **§13(d),(g)**– if fund owns more than 5% of a class of equity securities that are registered under §12, then have to file beneficial ownership statement – requires disclosure about the identity and background of the reporting person and about the acquisition of the security (might be able to file short schedule)
- **§13(f)** – quarterly reporting for managers that control aggregate fair value 100 million or more in equity securities
- **§15(b)** – Broker dealers are those that engage in business of buying and selling securities for own account as regular part of business (B/Ds must register) traders buy and sell securities for investment generally and don't have to register
- **§16 – (a)** must file initial report with Commission containing amount of ownership, and amend as it changes **(b)** short swing profit provisions relate to beneficial owners of 10% of a class of securities of company registered under 1934
- **§28(e)** – Safe Harbor: can pay > lowest rate for brokerage service (e.g. executing, lending stock):
 - advisor won't be deemed to have breached their fiduciary duties of best execution for paying higher commission to a B/D if they *in good faith believe* that the commission was **reasonable in relation to the value of the Brokerage services and Research**
 - SEC Interpretation:
 - Research Service: must be 1) **reasoning or knowledge** 2) re: a qualifying subject matter
 - Brokerage Service: services somehow relating to execution of trades
 - temporal standard: begins at time of order and ends at clearance & settlement
 - e.g. communications services incidental to settlement process qualifies
 - hardware does not qualify
 - if outside of safe harbor, have to disclose what you use soft dollars for in detail, but if in safe harbor then just have to tell client that you use soft dollars for “Brokerage Services and Research”

Advisers Act of 1940 (Advisor is ANYONE that gives out advice about investments for money)

- **Registration Process:** If need register (or voluntarily register) as investment adviser, must fill out form ADV
 - Part I--filed w/ SEC electronically.--Basically putting some bare bones information out there to SEC
 - **Rule 204-3.** Part II-of form ADV-not filed w/ SEC. Must be given to clients at least 48 hours before investment. Or must give written document that has same required information.
 - Champ: best practice (most efficient): basically just regurgitate the OM

- **§38a-1** – Mutual Funds, Board has to choose CCO for the fund, (advisor also has CCO) Fund CCO produces annual report to board
- **Registration Exceptions**
 - 203(b)(3): **1) Less than 15 Clients**, and **2) Not Holding out** to public as Investment Adviser and **3) not adviser to registered investment company**, OR
 - *Goldstein Funds are clients*, not investors
 - *Latham and Watkins*—Fund is client as long as 1) no individualized advice to investors (including no recommendation whether take cash or in kind distributions), and 2) adviser makes portfolio decisions based on objectives of fund as whole, not indiv. investors.
 - **Willkie Farr** – when have 2-tiered fund structure (top tier funds invest substantially all capital in bottom tier funds), don't have to count bottom funds as clients IF manager makes all decisions & only uses bottom funds to advise/invest for top funds
 - Asset test (**≤\$25 million** (total assets managed by advisor), don't have to register regardless)
- NOTE: IF RULES BELOW SAY “REGISTERED” THEN THEY APPLY TO ALL ADVISERS THAT ARE REGISTERED OR *REQUIRED TO BE REGISTERED* UNDER THE IA ACT.
- **Rule 204A-1** REGISTERED Advisors have to create written code of conduct
 - Fiduciary duties, comply with securities, report violations to CCO, access people must report their securities (holdings-annual and transactions-quarterly), give copy of code to access persons, access people need adviser's pre-approval for personal investments in ANY IPO
- **Rule 204-2** REGISTERED Advisors must keep books and records rule
 - Journals, ledgers, sales memoranda, check books, records of accounts, written agreements w/ clients, powers of attorney etc.
 - memo on each transaction stating date, terms/conditions, B/D, adviser, person who decided (usu. PM)
 - SEC: audit trail for all performance cited/marketed by advisor
 - *Bowen* letter: SEC: need to retain trade confirmation for each individual trade
- **Rule 204-3.** Part II-of form ADV-not filed w/ SEC. Must be given to clients at least 48 hours before investment. Or must give written document that has same required information.
- **§ 205** – NO REGISTERED Investment Advisor can charge incentive allocation, UNLESS:
 - **Rule 205-3(d)** Can Only Collect Carry from **Qualified Client** (at time of entering K)
 - 750k under management OR
 - More than 1.5 million net worth OR
 - QP OR
 - Knowledgeable employee
- **§ 206** shall be unlawful for **ANY advisor** to use mails, interstate commerce to

- (1) employ any device, scheme, or artifice to defraud client or prospective client
- (2) engage in any transaction, practice, or course of business which operates as fraud or deceit upon client or prospective client
- (3) to engage in principal sales or purchases w/out disclosing to client in writing and getting consent
 - Consent needs to come from investors, depends on your OM how many investors; can't approve yourself as GP b/c of the conflict of interest; DISCLOSURE is huge here
- (4) SEC will make rules (all that follow) to prohibit fraud
- **NO SCIENTER**: Pretty much the same as 17(a), commentators say NEGLIGENCE, in SEC v. Capital Gains, Supreme Court said no intent required b/c based on fiduciary duties
 - **Rule 206(4)-1 REGISTERED Advisor, Advertising Rule** (applies to advertising—any communication *to more than one person* that offers advisory service w/r/t securities. See *Clover*.)
 - NO: 1. Testimonials; 2. Can't tout winners unless disclose ALL fund positions or make them available; 3. Graphs, charts, formulas, diagrams – unless disclose limitations and difficulties; 4. Say things are free unless they are. 5. No untrue statement of material fact, not misleading (both cases below about this).
 - **Clover – Hypothetical Funds**; Maybe OK, not per se illegal. (Rare b/c they had newsletter record of ALL of their performance), 11 Factors
 - Champ: 3 factors: 1) different strategy?, 2) relevance?, 3) cherry picking?
 - **Horizon - Past Funds Performance** – OK if you were sole decision maker before and are going to be sole decision maker again.
 - **Rule 206(4)-2 REGISTERED Advisor (OLD RULE)**
 - Have a qualified custodian – that you reasonably believe sends statements to client (for managed accounts)
 - Exception for LLPs – don't have to send the detailed statement to clients or have surprise audit IF have annual audits
 - Exception – uncertificated and only available from issuer have to be held at custodian
 - **NEW CUSTODY RULE --REGISTERED**
 - 1. If private fund and have qualified custodian (i.e. registered B/D), then no surprise audit if have audited financial statements filed w/in 120 days after year end (audited statements by PCAOB-certified auditor)
 - 2. If managed account at QC, then surprise audit for advisor
 - 3. If custodian is related then SAS 70 internal structures review by PCAOB auditor AND advisor gets the surprise audit

- **Rule 206(4)-3 REGISTERED Advisors: Cash Payments to Solicitors (Finder's Fees)**
 - Solicitor can't have criminal record; if finder onshore must be reg. B/D to receive
 - Fee paid according to written agmt (terms: fee, re: disclosure to clients, etc.)
 - Separate written disclosure about solicitation fee given to client, must have written consent from client before entering advisory contract with client
- **Rule 206(4)-6 Proxy Voting: REGISTERED advisor has to write down proxy voting policies and disclose to clients. Also disclose how investor can find out how voted.**
- **Rule 206(4)-7 REGISTERED advisors must create written policies and procedures **reasonably designed** to prevent violations of rules under the IA act**
 - **Annual review** – adequacy of the procedure
 - SEC: review can't be privileged
 - **CCO – SEC:** needs to have enough power (formally and in reality) to enforce
- **Rule 206(4)-8** Constitute Fraud, deception, manipulation for **ANY** advisor to
 - 1. Make untrue statements of material fact or material omission
 - 2. Otherwise engage in any act practice or course of business that is fraudulent or deceptive to any **investor** or prospective investor in a pooled investment vehicle
 - Response to Goldstein, this is about investors;
 - **NO SCIENTER** (should be same as §206)
- Other Rules (no section known) under IA Act:
 - RULE: (REGISTERED ADVISOR) if an investor ever complains about something advisor required to be doing, a *registered* investment adviser has to 1) document/file complaint, and 2) respond to the investor. UNLESS the complaint is solely about performance.. 3) complaint must be distributed at adviser
 - Errors by Traders
 - Will probably have to go in Advisor's error account
 - SEC says B/D can fix error if in same day (if later can't help) (Contrast: in UK can't fix it)
 - Whether B/D will fix can be element of best execution
 - What you do with mistakes will be disclosed in the OM

Commodities Futures Trading Commission (CFTC) Registration

- Exception for 3c7 fund who engage in limited commodities trading
 - Fact that all investors are QPs is critical to get this exception

ERISA

- Become a ERISA fiduciary if
 - More than 25% of fund's securities are owned by benefit plans
 - If have one US pension investor, then all foreign pensions count against limit
 - Real Estate/ Venture Capital Exception
 - Exempt from ERISA if Fund has more than 50% of money invested in operating companies and have management roles at those companies
 - Regulation: no cross trades, extensive conflicts regulation, 3rd party valuations, stiff enforcement

FCC Requirements (rules against media investors investing in other media companies)

Anti-Money Laundering (onshore banks have extensive regulation, OFFSHORE: make sure your administrator runs investor list through Office of Foreign Asset Control List [can't take money from terrorists])

Blue Sky and World Sky Laws – Fund subject to states' and other countries' regulations

NASD Rules

- B/D's have to comply w/ NASD
- Main indicator of whether B/D is whether a **commission** is paid
- Obligations when selling HF: 1) balanced disclosure in promotional efforts, 2) reasonable basis suitability evaluation (look at security in general), 3) customer-specific suitability determination, 4) internal controls, 5) internal training regarding risks, features, of HF's
- Hot Issues: fund advisors can't get Hot Issues if their fund is in that investment area (B/Ds can't get hto issues either)
- B/D need to make sure that these less sophisticated investors understand hedge funds
- Need to evaluate new products (and create and follow written guidelines for doing so)
- Altegris – NASD RULE VIOLATION – statements didn't adequately disclose risk; didn't talk about leverage, volatility, used testimonials about unsupported future earnings
- CitiGroup – NASD RULE VIOLATION – cherry picking b/c picking portfolios of advisors that are winners, not showing all the advisors; also mixing real and hypothetical earnings

Cases and No Action Letters

- Advertising Issues Recap
 - see above for general solicitation (violates Reg D, 3c1, 3c7)
 - **Lamp Technologies – Electronic Disclosure** - to avoid violating general solicitation issues, can't just put up general website

- Lamp – used questionnaire to see if QP, then gave password, charged \$500 per month
 - Lamp II – lowered standard to Qualified Eligible Participant (2 mil. of investments) of the Commodities Exchange Act, and no subscription fee
 - Setting up account and/or cooling off period creates preexisting relationship
 - see above for 206(4)-1 (rule for advertising by registered investment advisers)
 - **Clover – Hypothetical Funds**; Maybe OK, not per se illegal. (Rare b/c they had newsletter record of ALL of their performance), 11 Factors
 - Champ: 3 factors: 1) different strategy?, 2) relevance?, 3) cherry picking?
 - **Horizon - Past Funds Performance** – OK if you were sole decision maker before and are going to be sole decision maker again.
 - see above for 17a, 10b (material misstatement in connection w/ purchase/ sale of security)
- **Millennium – Trade Secrets** – employees stole trade secrets (quant code) and were hired by competitor
- **Citadel** – employees broke **non-compete, non-solicitation, and non-disclosure** agreements
- Counting of Investors
 - **Latham** – TO avoid counting each investor as client: can give option of receiving partnership distributions in kind or in cash BUT cannot give any individual advice (including whether to take cash or in kind), AND advisor makes decisions for Fund’s interests not investors
 - **Willkie Farr** – when have two tiered fund structure, don’t have to count bottom funds as clients IF manager makes all decisions and only uses bottom funds for benefit of the top funds
- §206 Cases
 - **McKenzie Walker** – multiple funds, channeling Hot IPOs into the incentive allocation fund, under §206(2) they did not disclose these material facts, so are guilty of fraud, no intent needed
 - **Joan Conan** – PM bought debt warrants for herself, could have drastically helped fund, this is 206(2) material Info; also breached 10b5 by failure to disclose
 - Also violated here company’s compliance and reporting program
 - **Vaughn** – misled investors, told them she was going invest in “beta bond strategy” but really invested in bogus scheme and lost control of money (she is guilty for not disclosing this loss of control too) 17a, 10b5, 206
- Material Non-Public Information
 - **Berliner** – **made up MNPI rumor** about a merger’s price being reduced, simultaneously shorted that stock, then covered the stock for thousands of dollars of profits
 - 17(a) and 10b violations – DUTY – whenever you speak to market have duty to tell truth

- **Galleon Case** - elaborate **insider trading** scam involving multiple hedge funds and executives at large companies
 - **Chain of tipping** – at end as long as they know it was MNPI and was obtained in breach of duty, then are guilty under 10b5 and related rulings (but must be trade by someone)
- **Deephaven – PIPE** – was shorting the public shares of a company whose PIPEs he was selling as a b/d – was trading on MNPI about the PIPE. 10b5 and 17a violations. . (note: not 206 b/c did not involve selling to his investors)
- **Langley** – PIPE case – was trading on MNPI about the PIPE (17a, 10b5), but ALSO shorting the private shares before they were registered which is violation of §5 1933 Act
- **Bayou** - company falsified reports, made up fake auditing company, and misappropriated money from the funds
- **Bear Sterns** – found innocent by jury, even though they said in private correspondence to friends and family that the mortgage industry was toast, but were telling investors at same time they wer comfortable with their positions (also traded their own money out while telling investors that they were increasing their personal positions)
- Advisor Conflicts of Interest (may be FD issues)
 - OM often says potential conflicts of interest in that that
 - valuation practices (e.g. use fair value) give rise to an inherent COI (b/c fees are based on value of portfolio)
 - i.e. marking something up increases fees
 - adviser manages multiple funds and may be COI in determining which opportunity to allocate to which fund
 - limited access to IPO
 - agency cross transactions
 - principal transactions
 - agency transactions (i.e. w/ B/D, etc.)
 - Employees of the adviser may hold stock that is in the portfolio (at least when they join)
 - transactions with other funds owned by adviser
 - performance allocation fee may give rise to COI (incentive to take greater risks)
 - soft dollars--could give adviser more incentive more trades in order get more credits for adviser
 - any conflicts of interest arising from relationships w/ related parties
 - B/D (if related):
 - churning
 - best execution
 - researcher—quality of research services (best execution)
 - auditor—rep letter or if not independent

- **Gardener Russo – Agency Cross** – funds do not become the alter ego of advisor unless advisor owns 25% or more of fund, so would not be principal trade if owned less than 25%, but still issues
 - Need to set up in advance who to set the prices for the securities traded (closing price, valuation for illiquid securities, etc)
 - DO THESE FOR FREE, don't charge the fund commissions, get into conflict of interest issues
- **Kidder Peabody** – charged higher fees when doing principal trades than they were being charged for other trades, need to disclose these fees
 - Was also leveraging up his friends and family account with impermissible T-bill trading
- **Jamison** – in exchange for getting referrals, advisor would leave accounts at high commission b/d without disclosing to client that they could get cheaper commissions elsewhere
 - need to DISCLOSE, has conflict b/c getting referral benefit
- **Renberg** – BEST EXECUTION – had two funds, tax exempt account paid less commission than taxable account during agency cross Xactions – ENSURE FUNDS get same fees on agency cross
- Misuse of Soft Dollars
 - **Dawson-Sandburg** – paid for personal trips w/ soft \$ b/c charged to same AMEX as official travel & AMEX paid by B/D (when outside safe harbor must disclose in detail what do w/ soft \$)
 - **Sage** – used church endowment client's account to create excessive fees (churned the account, charged .30commissions) and then created shell company that was paid the soft dollars by the B/D and kept the soft dollars for themselves