Hedge Fund and Private Equity Fund:
Structures, Regulation and Criminal Risks

Duff & Phelps, LLC
Ann Gittleman, Managing Director
Norman Harrison, Managing Director
Speakers

Ann Gittleman is a managing director for the Disputes and Investigations practice. She focuses on providing expert forensic and dispute assistance in fraud and internal investigations, white collar investigations and compliance reviews. She is experienced in accounting and auditor malpractice matters, and related Generally Accepted Accounting Principles (GAAP) and Generally Accepted Auditing Standards (GAAS) guidance and damages. She has worked on U.S. regulatory investigations involving the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ).

Furthermore, she has a background in forensic accounting, asset tracing, commercial disputes, commercial damages, and lost profits analysis. Ann works on bankruptcy investigations, as a financial advisor in U.S. bankruptcies, purchase price and post-acquisition disputes, and Foreign Corrupt Practices Act (FCPA) reviews.

Ann is based in New York, has over 15 years of forensic accounting experience, and has led substantial international projects in the U.S., Europe, the Caribbean, and China. Ann has been retained as a testifying expert in numerous matters, including asset tracing, fraud and corruption, financial reporting, the application of GAAP and GAAS and damages calculations. She also frequently consults on complex accounting reporting and SEC matters.

Norman Harrison is a managing director at Duff & Phelps based in Washington, D.C. As a former corporate attorney, investment banker and investment fund principal, he has a wide range of experience at the intersection of regulation and the capital markets. Mr. Harrison advises clients in post-closing disputes, securities enforcement and financial fraud investigations, and fiduciary duty and corporate governance matters. He also consults with investment funds and their portfolio companies on operations, risk management, due diligence and compliance issues, and advises institutional fund investors in reviewing potential private equity and hedge fund sub-advisors.

Norman has conducted numerous internal investigations in matters arising from federal investigations, shareholder allegations, media exposés and other circumstances. He has also led multi-disciplinary teams in DOJ and SEC independent monitoring appointments.

He also has extensive experience relating to compliance monitoring. Norman has advised boards of directors and developed expert testimony on fiduciary duty and corporate governance issues arising in shareholder derivative suits and other civil litigation.
1. Introduction to Private Equity Funds and Hedge Funds

2. Legislative and Regulatory Framework
   a. The Securities Exchange Act of 1934
   b. Investment Advisers Act of 1940
   c. Federal Anti-Kickback Statute/False Claims Act

3. Risks Associated with Offshore Fund Structures & Strategies

4. High-Profile Fund Prosecutions and Enforcement Actions

5. Q&A
Alternative investments are assets that are not part of traditional asset classes such as cash, stocks, or bonds. Alternative investments include private equity funds, hedge funds, managed futures, real estate, commodities and derivatives contracts.

**Private Equity Fund**
- A fixed-life limited partnership whose investors agree to contribute capital to the Fund when requested by the Fund to make investments
- Typically acquire the majority, if not entire, stake in a company. These companies are not usually traded on a public exchange and therefore, are highly illiquid.
- After the purchase, the investment firm will seek to improve the company’s profitability (i.e., improving operations) to create an attractive return for the investors – customarily through a sale or IPO
- Holding periods of investments are generally three to six years

**Hedge Fund**
- A open-end limited partnership whose investors contribute capital to the fund to make investments in accordance with the fund’s investment strategy.
- Typically acquire minority ownership in securities through the application of an investment strategy that would provide a return at a certain level of risk
- Investments can be at all different asset levels (i.e., equity, debt, derivatives, options, commodities, currencies, etc.) and are typically liquid investments
- Holding periods of investments can range from seconds to years depending on the investment strategy applied
Private Equity and Hedge Fund Structure

• Capital can be raised from both U.S. and overseas accredited individuals and/or institutional investors. Therefore, a typical fund may have a general partner as well as U.S. limited partners and non-U.S. limited partners.

• Generally, if there are overseas investors, funds employ a “master-feeder” structure in which a separate fund entity is registered in an offshore jurisdiction.
  
  o Feeder funds are set up for the two categories of investors: a onshore fund and an offshore fund
    
    ▪ The Cayman Islands is a popular jurisdiction for the organization of offshore hedge funds, due primarily to its favorable tax and regulatory environment
    
    ▪ The so-called “offshore fund” serves the same purposes as the U.S.-based fund: to collect funds committed by investors, arrange for the investment of those funds, and remit funds to investors
  
  o In a traditional “master-feeder” structure, onshore and offshore “feeder” funds contribute to a single master fund from which investments are funded
Private Equity Fund Structure (Simplified)

- **Limited Partners (US taxable)**
- **Limited Partners (US tax exempted & Non-US)**
- **General Partner, LP/LLC**
- **Feeder Fund Delaware, LP**
- **Feeder Fund Cayman, Ltd**
- **Master Fund, LP**
- **Management Company, LLC**
- **Portfolio Company**
- **Portfolio Company**
- **Portfolio Company**
Hedge Fund Structure (Simplified)

Open-Ended

Limited Partners (US taxable)

Limited Partners (US tax exempted & Non-US)

Management Company, LLC

General Partner, LP/LLC

Feeder Fund Delaware, LP

Feeder Fund Cayman, Ltd.

Master Fund, LP

Equity/Debt Securities

Derivatives & Options

Other Investments
Management Fees and Related Offsets

• Annual management fees, collected by the management company, provide a revenue stream sufficient to cover the fund’s core operations – i.e., expenses such as salaries, insurance, office space, IT/equipment, legal fees, and auditors/accountants.

  – For private equity funds, the fee is customarily 1.5%-2.0% of the fund’s committed or contributed capital as of each measurement date (typically paid quarterly in advance).

  – For hedge funds, the fee is generally 1.5%-2.0% range of the market value of the fund’s holdings (its net asset value or “NAV”) as of each measurement date.

• Private equity fund managers often collect other fees from portfolio companies (e.g., directors’ fees, monitoring fees, transaction fees); these are typically offset against the management fee in whole or in part.
Performance Fees

• Funds seek a balance between providing meaningful performance incentives to fund managers while ensuring that the manager won’t be highly compensated if the fund doesn’t deliver attractive returns.

• A fund’s general partner receives a performance fee for profits generated by the fund’s investments, usually in an 80%-20% split with limited partners and general partner, respectively.
  – Performance/incentive fees typically arises only after investors have received a return of their invested capital plus a specified guaranteed (or “preferred”) return.

• Hedge fund performance fees are paid annually based on changes in NAV

• PE fund performance fees, also known as “carried interest”, are typically paid upon the liquidation of portfolio companies
The **Distribution Waterfall** details how proceeds from the fund’s realized investments and other cash inflows (such as dividends or interest payments) are allocated between the private equity fund’s general partners and limited partners.

<table>
<thead>
<tr>
<th>Tier</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier 1</td>
<td><strong>Return of Capital</strong></td>
</tr>
<tr>
<td></td>
<td>• 100% of distributions go to the limited partners until they recover all of their capital contributions</td>
</tr>
<tr>
<td>Tier 2</td>
<td><strong>LP Preferred Return</strong></td>
</tr>
<tr>
<td></td>
<td>• 100% of subsequent distributions go to limited partners until they receive the 7%-9% &quot;preferred return&quot; on their investment</td>
</tr>
<tr>
<td>Tier 3</td>
<td><strong>GP Catch-Up</strong></td>
</tr>
<tr>
<td></td>
<td>• 100% of the distributions go to the general partner until it receives a certain percentage of profits to catch up, typically 7%-9%</td>
</tr>
<tr>
<td>Tier 4</td>
<td><strong>Carried Interest</strong></td>
</tr>
<tr>
<td></td>
<td>• All remaining distributions are allocated 80% to the limited partners and 20% “carried interest” to the general partner</td>
</tr>
</tbody>
</table>
Example of a “Waterfall” Calculation

- Assume a $250MM capital contribution with 7% preferred return and a 7% GP catch up
- LPs entitled to return of capital plus preferred return before carry payable
- Fund sells portfolio company during Year 5, for proceeds of $500MM

<table>
<thead>
<tr>
<th>Limited Partners</th>
<th>General Partner</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 0: Capital Contribution: $250MM</td>
<td>$ (250,000,000)</td>
</tr>
<tr>
<td>Year 5: Sale of Investment: $500MM</td>
<td>-</td>
</tr>
<tr>
<td>Waterfall Calculation:</td>
<td>-</td>
</tr>
<tr>
<td>Return of Capital</td>
<td>250,000,000</td>
</tr>
<tr>
<td>7% LP Preferred Return</td>
<td>17,500,000</td>
</tr>
<tr>
<td>GP 7% Catch Up</td>
<td>-</td>
</tr>
<tr>
<td>Carried Interest (80%/20%)</td>
<td>172,000,000</td>
</tr>
</tbody>
</table>
The “Clawback”

- Some funds allocate carried interest only after LPs have obtained a return of all of their contributed capital (plus a preferred return), while others allocate carry on a per-deal basis.

- Per-deal carry is more generous to the GP and might also incentivize GP to:
  - Liquidate holdings prematurely (leaving potential additional value unrealized) and
  - Avoid resolving poorly performing companies until the later years of the fund’s life (incurring losses more severe than necessary).

- To mitigate these risks, fund operating agreements typically include a “clawback”: if GP has been paid excessive carry based on the overall performance of the fund upon its termination, GP will repay excess distributions.
The **High Water Mark** clause states that the manager can only collect performance fees on ‘new’ profits. If the fund incurs a loss, then the manager has to recover these losses before it can charge a performance fee.

### Terms that Impact the Performance Fee

**Hurdle Rate**
- Hurdle rates are guarantee that the fund achieves a minimum level of return before any incentive fees are collected.

**Crystallization**
- The frequency at which investors have to pay incentive fees to the manager. Once a fund crystalizes, a new high water mark is set.

**Redemptions**
- If an investor redeems during the fiscal year, their pro rata share will be crystallized to determine if there is any performance fee is due to the GP.
Example of a High Water Mark Calculation

- Assume an initial contribution of $100MM with a 7% hurdle rate and 20% incentive fee
- The Fund is crystallized annually and the high water mark is reset at year end

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning Gross Net Asset Value</th>
<th>Ending Gross Net Asset Value</th>
<th>Hurdle Rate</th>
<th>Incentive Fee</th>
<th>End Value Net of Fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$100,000,000</td>
<td>$150,000,000</td>
<td>$7,000,000</td>
<td>$8,600,000</td>
<td>$141,400,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>141,400,000</td>
<td>160,000,000</td>
<td>9,898,000</td>
<td>1,740,400</td>
<td>158,259,600</td>
</tr>
<tr>
<td>Year 3</td>
<td>158,259,600</td>
<td>200,000,000</td>
<td>11,078,172</td>
<td>6,132,446</td>
<td>193,867,554</td>
</tr>
</tbody>
</table>
## Summary

<table>
<thead>
<tr>
<th></th>
<th>Private Equity Funds</th>
<th>Hedge Funds</th>
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</thead>
<tbody>
<tr>
<td><strong>Fund Life</strong></td>
<td>Seven to ten years</td>
<td>Indefinitely</td>
</tr>
<tr>
<td><strong>Investors</strong></td>
<td>High net worth individuals and institutions</td>
<td>High net worth individuals and institutions</td>
</tr>
<tr>
<td><strong>Investments</strong></td>
<td>Typically private companies</td>
<td>Typically liquid alternative assets</td>
</tr>
<tr>
<td><strong>Fees Collected</strong></td>
<td>Management fees plus a percentage of profit</td>
<td>Management fees plus a percentage of profit</td>
</tr>
<tr>
<td><strong>Liquidity</strong></td>
<td>Not liquid; committed for the life cycle of the fund</td>
<td>Has a lock-up period, then it is relatively liquid</td>
</tr>
</tbody>
</table>

Duff & Phelps
Key Parties

- **Management Company**: Members include the fund’s investment team and others who operate the day-to-day business of the fund and investment firm.

- **General Partners**: Responsible for managing the investments within the fund. Typically have a small ownership interest in the fund. For their services, they earn a carried interest or incentive fee.

- **Limited Partners**: Institutional or high net worth investors interested in receiving the income and capital gains associated with investing in the private equity or hedge fund. Limited partners do not take part in the fund’s active management. They are protected from losses beyond their original investment as well as any legal actions taken against the fund.

- **Custodian**: Bank that maintains possession of the fund’s cash and securities (JPM, BNY Mellon, Goldman, Citi, State Street, BOA, Morgan Stanley, Deutsche Bank, UBS).

- **Fund Administrator**:  
  - Hedge funds: Valuation/NAV, accounting, LP account administration/reporting, calculation of incentive fees  
  - PE funds: Not as common – account administration, carried interest calculations, accounting, compliance support

- **Offshore Fund Administrator**: Regulatory compliance, registered office, directors for offshore feeder fund.

- **Auditor**: Conducts annual independent audit; audit report distributed to investors.
Outline of Contents

1. Introduction to Private Equity Funds and Hedge Funds
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The Securities Exchange Act of 1934 is the principal federal securities fraud statute, which also created the Securities and Exchange Commission.

- Requires periodic disclosures of material financial and other information by issuers of publicly traded equity securities
- Also prescribes disclosure requirements in numerous other situations, including:
  - Material holdings of securities
  - Insider transactions in securities
  - Solicitation of proxies (shareholder voting)
  - Tender offers
- Also governs broker-dealers and the organized securities exchanges
Many of the disclosure obligations under the Exchange Act are enforced by the SEC through its civil enforcement authority:

<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
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<tbody>
<tr>
<td><strong>Section 10(b):</strong></td>
<td>General prohibition on use of “any manipulative or deceptive device or contrivance” in connection with a purchase or sale of a registered security; scienter requirement</td>
</tr>
<tr>
<td><strong>Section 14(e):</strong></td>
<td>Makes it unlawful to disclose to a third party or trade on material nonpublic information about a pending or commenced tender offer</td>
</tr>
<tr>
<td><strong>Section 18:</strong></td>
<td>Liability for materially false or misleading statements in an Exchange Act filing to any person who purchases or sells securities in reliance</td>
</tr>
</tbody>
</table>
The Securities Exchange Act of 1934: Criminal Liability

• However, Section 32 also provides criminal penalties for most violations of the Exchange Act and the SEC implementing rules:

• Any person who:
  
  – willfully violates any provision of the Exchange Act, or any rule or regulation thereunder the violation of which is made unlawful; or
  
  – willfully and knowingly makes, or causes to be made, any false or misleading statement in any application, report, or document required to be filed under the Exchange Act or any rule or regulation thereunder or any undertaking contained in a registration statement:
    
    – shall upon conviction be fined not more than $5,000,000 (or $25,000,000 if an entity), or imprisoned not more than 20 years, or both.

• SEC refers matters to DOJ for prosecution; violators often subject to civil proceedings and criminal prosecution
The Securities Exchange Act of 1934: Section 13(d)

Section 13(d) requires a person (the “beneficial owner”) who acquires more than five percent of a class of registered equity securities to publicly report its holdings on SEC Schedule 13D within 10 days of crossing the 5% threshold.

**Section 13(d) Disclosures:**

<table>
<thead>
<tr>
<th>• the acquisition or disposition of additional securities of the issuer</th>
<th>• an “extraordinary” corporate transaction, such as a merger</th>
</tr>
</thead>
<tbody>
<tr>
<td>• a sale of “a material amount” of the issuer’s assets</td>
<td>• any change in management or composition of the board of directors</td>
</tr>
<tr>
<td>• any material change in the issuer’s capitalization or dividend policy</td>
<td>• any other material change in the issuer’s business or corporate structure</td>
</tr>
<tr>
<td>• changes in the issuer’s charter, by-laws or other governing documents</td>
<td>• causing the delisting of the issuer’s securities from a national securities exchange</td>
</tr>
<tr>
<td>• terminating the registration of any class of the issuer’s securities</td>
<td>• any action similar to those listed here</td>
</tr>
</tbody>
</table>
The Securities Exchange Act of 1934: Section 13(g)

- Section 13(g) of the Exchange Act provides an alternative, abbreviated disclosure option for certain categories of five percent shareholders whose holdings do not implicate the policy concerns underlying the more detailed Schedule 13D disclosures.

- Holders who satisfy one of the Section 13(g) criteria may instead report their holdings on SEC Schedule 13G.

- Schedule 13G is available to certain categories of qualified institutional investors, including private equity and (non-activist) hedge fund managers, who acquired the securities in question:
  - “in the ordinary course of business” and
  - “not with the purpose nor with the effect of changing or influencing the control of the issuer”
The Securities Exchange Act of 1934: Section 13(f)

• Under Section 13(f)(1) of the Exchange Act, investment advisers who manage more than $100 million in value of securities to which Section 13(f) applies are required to submit quarterly reports to the SEC on Form 13F.

• Form 13F discloses, among other things, the size and market value of all of the adviser’s positions in covered securities.

• Form 13F must be filed within 45 days of the end of each calendar quarter ending in March, June, September and December

• Provides useful tool to track accumulations or liquidations of holdings by activist hedge funds
<table>
<thead>
<tr>
<th>COLUMN 1</th>
<th>COLUMN 2</th>
<th>COLUMN 3</th>
<th>COLUMN 4</th>
<th>COLUMN 5</th>
<th>COLUMN 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>NAME OF ISSUER</td>
<td>TITLE OF</td>
<td>CUSIP</td>
<td>VALUE (x$1000)</td>
<td>PRN AMT</td>
<td>DISCRETION</td>
</tr>
<tr>
<td>AUTOMATIC DATA PROCESSING IN</td>
<td>COM</td>
<td>053015103</td>
<td>901,253</td>
<td>7,941,957 SH</td>
<td>SOLE</td>
</tr>
<tr>
<td>CHIPOTLE MEXICAN GRILL INC</td>
<td>COM</td>
<td>169656105</td>
<td>931,353</td>
<td>2,882,463 SH</td>
<td>SOLE</td>
</tr>
<tr>
<td>HOWARD HUGHES CORP</td>
<td>COM</td>
<td>44267D107</td>
<td>306,717</td>
<td>2,204,534 SH</td>
<td>SOLE</td>
</tr>
<tr>
<td>MONDELEZ INTL INC</td>
<td>CL A</td>
<td>609207105</td>
<td>674,215</td>
<td>16,156,591 SH</td>
<td>SOLE</td>
</tr>
<tr>
<td>PLATFORM SPECIALTY PRODS COR</td>
<td>COM</td>
<td>72766Q105</td>
<td>389,548</td>
<td>40,451,506 SH</td>
<td>SOLE</td>
</tr>
<tr>
<td>RESTAURANT BRANDS INTL INC</td>
<td>COM</td>
<td>76131D103</td>
<td>1,384,311</td>
<td>24,320,295 SH</td>
<td>SOLE</td>
</tr>
<tr>
<td>UNITED TECHNOLOGIES CORP</td>
<td>COM</td>
<td>913017109</td>
<td>244,647</td>
<td>1,944,420 SH</td>
<td>SOLE</td>
</tr>
</tbody>
</table>

• The most important civil and criminal liability provision of the federal securities laws

• To prevail on a civil 10b-5 claim, a plaintiff must provide that the defendant:
  – Made a false statement or omission of a material fact
  – With scienter
  – In connection with the purchase or sale of a security
  – Upon which the plaintiff justifiably relied, and
  – Which proximately caused economic loss to the plaintiff

• Violations enforceable by the SEC in civil penalty and injunctive actions, by DOJ for willful violations (under Section 32), and in private actions by purchasers and sellers.
Rule 10b-5: Insider Trading

• To recap, liability for insider trading involves:
  – Buying or selling securities
  – On the basis of material, non-public information (“MNPI”)
  – In breach of a duty of trust and confidence owed (by someone, not necessarily the trader) either:
    » To shareholders of the issuer of the securities, or
    » To the source of the MNPI

• “Tipper” must have disclosed information in breach of a duty and received a “personal benefit” from giving the information
  – Recent *Newman* decision clarified that “personal benefit” must involve a quid pro quo or something of tangible value; casual friendship not enough.

• “Tippee” liability limited to circumstances involving a misappropriation of information or participation in tipper’s violation of a fiduciary duty by insider/tipper
Insider Trading by Investment Funds: Examples

• Trading on or sharing information about:
  – A fund’s accumulation of a > 5% position prior to Section 13 disclosure
  – A plan to mount a proxy contest or otherwise engage in an “activist” campaign involving a portfolio company
  – Securities transactions by insiders prior to disclosure under Section 16
  – A planned or pending tender offer – by any person:
    » In possession of material information relating to the offer;
    » Which the person knows or has reason to know is MNPI; and
    » Knows or has reason to know was acquired from the offering person or issuer
The Securities Exchange Act of 1934: Section 14(a)

- Section 14(a) of the Exchange Act prohibits material misrepresentations and omissions in proxy statements sent to stockholders of registered securities.

- SEC Rule 14a-9 provides that:
  
  “No solicitation subject to this regulation shall be made by means of any proxy statement . . . containing any statement which . . . is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading.”

- Proxy statements are most often disseminated:
  - Prior to the annual shareholders’ meeting, to solicit shareholder votes on proposals
  - In connection with an M&A transaction, to solicit the affirmative vote of the target company’s shareholders
The Securities Exchange Act of 1934: Section 14(d)

• A tender offer is a broad solicitation by a company or a third party to purchase a substantial percentage of a company’s registered, publicly traded shares of stock.

• Section 14(d)(1) of the Exchange Act prescribes certain disclosure and filing requirement in connection with any tender offer for more than five percent of a class of a registered, publicly traded equity security.
  – Applies only to third parties, not the issuer’s own stock.

• The SEC’s Regulation 14D sets forth the principal filing, dissemination and disclosure requirements with respect to third party tender offers.
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The ‘40 Act was created to monitor and regulate the activities of investment advisors after the stock market crash in 1929.

- Applies to any person or firm that (i) for compensation, (ii) is engaged in the business of, (iii) providing advice to others or issuing reports or analyses regarding securities [§ 202(a)(11)]
- Applies to PE and hedge funds advisors, with an exemption for those that solely advise funds with less than $150MM in AUM in the United States
- **Affiliation rule**: advisers may not avoid registration by creating affiliated adviser entities to manage <$150MM pools
  - Advisers that are “operationally integrated” – i.e., share personnel, capital structures and investment functions – are deemed to be a single entity
**Investment Advisers Act of 1940 (the ’40 Act)**

- Advisers apply for registration on SEC **Form ADV**, which is subject to SEC review and approval.
- Form ADV consists of two parts (which must be updated at least annually):

<table>
<thead>
<tr>
<th>Part 1</th>
<th>Part 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disclosure to SEC about adviser’s business, ownership, clients, personnel, business practices/conflicts, disciplinary actions, non-advisory activities, industry affiliations</td>
<td>Client brochure and brochure supplement is a detailed narrative describing the types of advisory services offered, the fee schedule of the adviser, disciplinary actions, conflicts of interest, and management background.</td>
</tr>
<tr>
<td>Major Rules &amp; Requirements of the ’40 Act</td>
<td></td>
</tr>
<tr>
<td>------------------------------------------</td>
<td></td>
</tr>
</tbody>
</table>
| **Fiduciary Duties to Clients** | Obligation to avoid conflicts or take unfair advantage of client’s trust, including:  
   - Full disclosure of material facts (including conflicts)  
   - Suitability, reasonableness of advice  
   - Best execution of trades (soft dollars, safe harbor) |
| **Client Transactions**  
 [Section 206(3)] | Adviser may not, acting as principal for its own account, sell securities to or purchase securities from a client without full disclosure and obtaining client’s consent |
| **Advertising**  
 [Rule 206(4)-1] | Prohibits any advertisement that contains any untrue statement of material fact or is otherwise misleading (with particular emphasis on testimonials, prior recommendations, historical performance) |
## Major Rules & Requirements of the ’40 Act

<table>
<thead>
<tr>
<th>Rule 206(4)-2 (The Custody Rule)</th>
<th>Adviser must:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• maintain client funds and securities with “qualified custodian”</td>
<td></td>
</tr>
<tr>
<td>• have “reasonable basis” to believe that custodian provides quarterly account statements</td>
<td></td>
</tr>
<tr>
<td>• notify clients as to where and how funds/securities will be maintained</td>
<td></td>
</tr>
<tr>
<td>• arrange surprise annual exam by independent audit firm</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Rule 206(4)-3 (Use of solicitors)</th>
<th>Adviser must:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Written agreement must detail activities and fees; solicitor must provide ADV Part 2 and disclose fee arrangements to prospective clients</td>
<td></td>
</tr>
</tbody>
</table>
## Major Rules & Requirements of the ’40 Act

<table>
<thead>
<tr>
<th>Rule 206(4)-5</th>
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</thead>
<tbody>
<tr>
<td><strong>“Pay to Play” Rule</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Anti-Fraud Provision [Rule 206(4)-8]</strong></td>
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<th>• Response to CalPERS scandal – former CEO convicted of accepting bribes to direct investments to PE funds  &lt;br&gt;• Adviser prohibited from receiving compensation (i.e., management fees) from a government entity within two years of making a contribution to an official of the entity who can influence the award of advisory business  &lt;br&gt;• May not pay a third party to solicit government clients unless solicitor is regulated as an investment adviser, broker-dealer or municipal adviser</th>
</tr>
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<tbody>
<tr>
<td>Prohibits advisers from defrauding investors and prospective investors in private equity, venture capital and hedge funds they advise</td>
<td></td>
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<tr>
<td>• Applies to false and misleading statements, as well as to other fraudulent conduct that might not involve statements</td>
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# Major Rules & Requirements of the ’40 Act

## The Compliance Rule
**[Rule 206(4)-7]**

Adviser must establish internal compliance program that addresses its performance of its duties and obligations under the Advisers Act

- Designation of Chief Compliance Officer
- Adoption and implementation of *risk-based* policies and procedures; must include:
  - Portfolio management/trade allocations
  - Best execution/soft dollar arrangements
  - Proprietary and personal trading activities
  - Accuracy of disclosures to clients
  - Custody
  - Business records
  - Marketing and advertising
  - Valuation practices
  - Data protection and business continuity plans

## Insider Trading Provision
**[Section 204A]**

Requires advisers to establish, maintain and enforce written policies and procedures to prevent the misuse of material, non-public information by the adviser or its personnel

- More on this later
Outline of Contents

1. Introduction to Private Equity Funds and Hedge Funds

2. Legislative and Regulatory Framework
   a. The Securities Exchange Act of 1934
   b. Investment Advisers Act of 1940
   c. Federal Anti-Kickback Statute/False Claims Act

3. Risks Associated with Offshore Fund Structures & Strategies

4. High-Profile Fund Prosecutions and Enforcement Actions

5. Q&A
The Federal Anti-Kickback Statute/False Claims Act

The Federal Anti-Kickback Statute and False Claims Act affect various industries including military suppliers, pharmaceutical manufacturers, and health care providers.

The Federal Anti-Kickback Statute

- Prohibits the exchange of (or offer to exchange) anything of value in an effort to induce (or reward) the referral of federal health care program business (e.g., paying commissions or kickbacks for Medicare patient referrals)

False Claims Act

- The Federal whistleblower statute – imposes civil and criminal liability on persons who submit fraudulent claims for government payments (i.e., contract fraud)
  
  » Includes a “qui tam” position that provides a potential recovery to persons (“relators”) who disclose fraud to the government
AKS/FCA: Investment Adviser Risks

• Several recent FCA cases involving privately held companies have included PE funds and their managers as defendants

• Cases allege that fund controlled the defendant and its conduct due to the fund’s ownership stake and/or representation on board of directors

• Fund as “deep pocket”

• Theories of liability:
  – Veil piercing
  – Direct liability – especially in cases where fund’s “operating executives” are serving in senior management roles, and/or the fund controls or has significant representation on board
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Foreign Corrupt Practices Act

• Five elements of an FCPA offense:
  – a payment, offer, authorization, or promise to pay money or anything of value;
  – to a foreign government official (including a party official or manager of a state-owned enterprise), or to any other person, knowing that the payment or promise will be passed on to a foreign official;
  – with a corrupt motive;
  – for the purpose of (a) influencing any act or decision of that person, (b) inducing such person to do or omit any action in violation of his lawful duty, (c) securing an improper advantage, or (d) inducing such person to use his influence to affect an official act or decision;
  – in order to assist in obtaining or retaining business for or with, or directing any business to, any person.
FCPA Risks for Investment Funds

• “Pay to Play” – bribing foreign government officials to secure investment commitments from a country’s sovereign wealth fund

• Bribing government officials to obtain access to investment opportunities in government-owned or controlled industries or companies
  – High risk in countries with high rates of public corruption (e.g., China, Russia, Brazil) and in emerging markets generally

• Use of “consultants” or “finders” or other intermediaries to secure funds or investment opportunities in high-risk jurisdictions

• Liability arising from portfolio company conduct if fund owns a controlling stake (e.g., an emerging markets private equity fund)
Anti-Money Laundering (AML) Regulations

- The Bank Secrecy Act (BSA) and USA PATRIOT Act prescribe numerous monitoring and reporting requirements for “financial institutions” that are designed to combat money laundering.

- BSA seeks to deter the use of offshore accounts to funnel or “launder” the proceeds of criminal activity by prescribing regulatory reporting and recordkeeping requirements for transactions in currencies and monetary instruments.

- The USA PATRIOT Act expanded the definition of “financial institutions” to include investment advisers, among others, and added significant new provisions designed to counter the financing of terrorism (CFT).
Anti-Money Laundering (AML) Regulations

Three phases of a typical money laundering scheme:

- **Placement**
  Getting dirty money into the established financial system (usually in the form of cash or cash equivalents)

- **Layering**
  Moving money around to disguise its true origin – e.g., by purchasing fixed assets or investing in a hedge fund

- **Integration**
  Movement of laundered money back into the financial system – e.g., by selling the asset or redeeming the hedge fund interest
Hedge Funds as Layering or Integration Mechanism

- Preservation of capital is a primary investment objective
- High minimum investment requirements
- Short lock-up period
- Limited restrictions on redemptions/withdrawals
- Little transparency – increases in fund’s NAV provides plausible explanation for origin of money
- Little transparency – use of custodian banks (sometimes multiple tiers) may conceal identity of ultimate investor
- Infinite life provides time and plausible legitimacy
- Use of tax havens for offshore feeder funds facilitates disguise of beneficial ownership
U.S. Sanctions Regime

• The Treasury Department’s Office of Foreign Assets Control (OFAC) enforces economic and trade sanctions against targeted foreign countries and regimes, terrorists, international narcotics traffickers, those engaged in WMD proliferation, and other threats to U.S. national security, foreign policy or economic security

• OFAC maintains a list of “Specially Designated Nationals and Blocked Persons” and a list of countries subject to OFAC-administered sanctions

• List of blocked or sanctioned countries currently includes the Balkans, Belarus, Burundi, Central African Republic, Cuba, Democratic Republic of the Congo, Iran, Iraq, Lebanon, Libya, North Korea, Somalia, Sudan/Darfur, South Sudan, Syria, Ukraine/Russia, Venezuela, Yemen and Zimbabwe
Hedge Fund Sanctions Risks/Enforcement

• Risks arise for reasons similar to those explained above in AML context:
  – Offshore fund structures with third country beneficial owners
  – Lack of transparency regarding beneficial owners
  – Investments made through intermediary funds/entities – a key enforcement area because U.S. sanctions programs prohibit U.S. persons from *facilitating or participating in* a transaction with a sanctioned country
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Galleon Group Prosecutions

Background
• Galleon Group was one of the largest hedge fund management firms in the world, with more than $7 billion in assets under management.
• In October 2009, Raj Rajaratnam, founder of the Galleon Group hedge fund, and five others were arrested and charged with multiple counts of fraud and insider trading.

Allegations
• Rajaratnam reaped illicit trading gains of over $60 million from a network of well-placed tipsters at companies including Intel, Goldman Sachs and McKinsey.

Conclusion
• Rajaratnam was convicted and sentenced to 11 years in prison in October 2011.
• This case was significant because the evidence consisted primarily of recorded phone conversations (traditionally used more commonly in organized crime cases) of Rajaratnam talking to tipsters about pending transactions or major disclosures.
# S.A.C. Capital Prosecutions

## Background
- S.A.C. Capital was a $14 billion hedge fund manager founded by Steven A. Cohen.
- Two senior traders of SAC Capital, Mathew Martoma and Michael Steinberg, were indicted in July 2013 for engaging in insider trading, based on information provided by high-level contacts at public companies Wyeth Pharma, Elan Pharma and Invidia Corp.

## Allegations
- S.A.C. Capital obtained approximately $300 million in gains and avoided losses as a result of the insider trading.

## Conclusion
- S.A.C. Capital pleaded guilty to insider trading charges and paid $1.2 billion in penalties.
- Cohen was never charged, but closed the firm and accepted a two-year ban on managing third-party assets.
- Both senior traders were convicted of securities fraud: Martoma lost on appeal, and the Steinberg conviction was overturned post-Newman because he was unaware that fund was paying tippers for the information.
Section 10(b): Ponzi Schemes

- Gave his name to (but did not invent) the “Ponzi scheme” – a category of investment fraud in which handsome returns are promised from non-existent sources and early investors are paid investment “returns” with money from later investors.

- The actual Ponzi scheme involved purchasing “international reply coupons” (vouchers that could be exchanged for minimum U.S. postage back to the country from which a letter was sent) cheaply in foreign countries, swapping them for stamps of higher value in the U.S. (especially as postal and exchange rates fluctuated), then selling the stamps at a profit.

- Initial “scheme” not illegal; difficulty arose when he raised third-party funds and promised 50%-100% annual investment returns.

- As with all such schemes, the pyramid collapsed when investors demanded redemption of their funds – in this case, after Clarence Barron, owner of the Wall Street Journal, began an investigation.
Bernard Madoff: Ponzi Scheme

Background
• Bernard L. Madoff Investment Securities LLC was one of the largest frauds in history
• Bernard "Bernie" Madoff admitted that the wealth management arm of his business was an elaborate Ponzi scheme.

Allegations
• Indictment alleged that Madoff “deceived investors by operating a securities business in which he traded and lost investor money, then paid certain investors purported returns on investment with the principal received from other, different investors, which resulted in losses of approximately billions of dollars.”

Conclusion
• The scheme collapsed in wake of the 2007-2008 financial crisis, when investors demanded redemption of capital in flight to liquidity.
• Estimated losses were over $65 billion.
• Madoff was indicted on December 11, 2008 for violations of Section 10(b) and Rule 10b-5.
• Madoff was sentenced to 150 years in prison on June 29, 2009.
Platinum Partners Fraud

Background
• Platinum Partners was an U.S. based hedge fund with over $1.7 billion in assets under management.
• Platinum Partners’ founder, Mark Nordlicht, and six others were charged in a $1 billion securities fraud indictment for operating the firm like “a ponzi scheme.” One of the largest alleged scams since the Bernard Madoff Ponzi scheme.

Allegations
• Prosecutors alleged that Platinum tapped prominent families and foundations within the Orthodox Jewish community in New York to fuel high-stake bets on payday lenders and oil companies. These investments and the firm’s performance were overvalued.
• Platinum took in new money in order to pay longtime investors who wanted their money back, making preferential repayments to some of the customers.
• They also concealed cash flow problems in their signature fund.

Conclusion
• Trial is currently underway.
Michael Kenwood Group: FCPA, Ponzi Scheme

Background
- Francisco Illarramendi, founder of hedge fund managers Michael Kenwood Capital and Highview Point Partners, was convicted of orchestrating a Ponzi scheme that defrauded investors hundreds of millions of dollars.

Allegations
- Illarramendi deceived investors about value of the funds’ holdings by creating fraudulent debt instruments and asset verification letters. This was considered a classic Ponzi scheme with commingling assets of separate funds in order to meet redemption requests.
- Illarramendi and his funds paid over $30 million in bribes to officials of PDVSA, the Venezuelan state oil company, to steer at least $100 million in pension money into the funds and to provide access to profitable bond and currency transactions.

Conclusion
- Illarramendi was sentenced to 13 years in prison on charges of securities fraud, wire fraud and obstruction of justice.
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