CONFLICTS OF INTEREST

Recommended Actions for Hedge Fund Managers in Light of SEC Enforcement Trends

By Vincent Pitaro

A program presented by The Hedge Fund Law Report and ACA Compliance Group (ACA) extracted compliance lessons for hedge fund managers from recent SEC enforcement actions in the areas of conflicts of interest, fees and expenses, chief compliance officer (CCO) liability, compliance resources and technology. The program, entitled “What Hedge Fund Managers Need to Know About SEC Enforcement Trends,” was moderated by William V. de Cordova, Editor-in-Chief of The Hedge Fund Law Report, and featured Barry P. Schwartz, founding partner of ACA, Kent Wegrzyn, managing director of ACA, and Mark Borelli, a partner at Sidley Austin. This article summarizes the key takeaways from the program. For more from the panelists, see our two-part series on “The SEC’s Broken Windows Approach,” Part One, Vol. 8, No. 37 (Sep. 24, 2015); and Part Two, Vol. 8, No. 38 (Oct. 1, 2015).

SEC Enforcement Generally

Wegrzyn said that the SEC Division of Enforcement and its examination teams have been “very aggressive” this year. The SEC filed 755 enforcement actions in 2014 – the most ever and a 10% increase over the 686 actions it filed in 2013. He noted that the Dodd-Frank whistleblower provisions have been yielding fruit for the SEC. In addition, the SEC has been more willing to take action against individual wrongdoers.

Conflicts of Interest

Conflicts of interest at private fund managers and investment advisers remain a priority for the SEC. Schwartz noted that in a February 2015 speech, Julie M. Riewe, Co-Chief of the Asset Management Unit of the SEC Division of Enforcement, said that in nearly every matter her unit is involved in, it looks at whether an adviser identified potential conflicts of interest and either eliminated them or took steps to mitigate and disclose them to investors. The SEC may consider failure to address conflicts of interest a violation of the anti-fraud provisions of the Investment Advisers Act of 1940 (Advisers Act). Such speeches, Schwartz said, often provide insights on “what is next on the docket.”

Schwartz discussed the recent enforcement action against Guggenheim Partners Investment Management, LLC (GPIM), in which a senior GPIM executive, in violation of firm policy, borrowed $50 million from a client so that he could participate personally in a firm investment. GPIM subsequently entered into several transactions that involved the client/lender and other advisory clients without disclosing the existence of the loan to the other clients.

Schwartz outlined three lessons from the action:

1. Some conflicts are so significant there should be specific disclosure at the time of a transaction, rather than (or in addition to) general disclosures in offering documents.
2. “Procedures matter.” Somewhere in GPIM's compliance manual was a prohibition on borrowing from clients; employees must read and follow those materials.
3. In an enforcement action, the SEC is likely to include all violations it finds, even minor ones. Here, the SEC also cited GPIM for employees’ violations of its gift and entertainment policies and for inaccurate recordkeeping.

No compliance personnel were charged, Schwartz observed, apparently because they had been unaware of what was happening. He noted that there was also no allegation that any client was harmed. The $20 million penalty imposed on GPIM shows the
appropriate person or department.
4. Employee compliance certifications are important, but the compliance function must also conduct its own tests. Schwartz said that such testing may include public searches on Google, Facebook and other Internet sites; review of firm financials to detect money flows to outside activities; review of personal trading records; and email surveillance.
5. A firm must document the steps it has taken to address an issue; failure to do so could tip the scales in favor of a charge against its CCO.

Fees and Expenses

Borrelli noted three drivers of enforcement actions involving fees and expenses. First, many practices long accepted by advisers may be viewed by the SEC as violating advisers’ duties to clients; wide acceptance of a particular practice is not an excuse for failing to make proper disclosures. Second, the SEC found fee and expense problems in more than half of its examinations of newly registered advisers, which prompted it to examine the issue more closely. Finally, the SEC sees fees and expenses as “fundamental issues.”

Charging a fund for a manager’s overhead is now an “off-market” practice, said Borrelli, so managers that do so must ensure there are clear disclosures. The same is true for soft dollars; disclosure is always needed, but the further outside the safe harbor found in Section 28(e) of the Securities Exchange Act of 1934 that a manager goes, the clearer the disclosure must be.

Borrelli discussed the parallel enforcement actions against investment adviser Alpha Titans LLC and its auditor concerning the adviser’s payment of its operating expenses out of a fund that it advised. The SEC alleged that Alpha Titans violated the anti-fraud provisions of the Advisers Act and the custody rule because the
fund’s organizational documents did not clearly permit such charges. The SEC charged the auditor with failing to follow generally accepted auditing standards, aiding and abetting Alpha Titans’ violation of the custody rule. See “Inadequate Disclosure of Expense Allocations May Carry Unintended Consequences,” The Hedge Fund Law Report, Vol. 8, No. 19 (May 14, 2015).

The SEC included the custody rule charges “because they could,” observed Borrelli. When financial statements fail to comply with generally accepted accounting principles, there will usually be a violation of the custody rule, because virtually all advisers rely on the audited financial statement exemption to that rule. In Borrelli’s experience, the SEC includes charges for less serious offenses because examiners want enforcement personnel to charge all the violations that they find and because enforcement cases are reviewed by other divisions of the SEC which may request particular charges.

In another case, Borrelli said, the SEC charged Kohlberg Kravis Roberts & Co. L.P. (KKR) with improperly allocating broken deal expenses to the funds it managed without allocating a portion of those expenses to co-investors after failing to identify or address the problem for several years. KKR agreed to pay disgorgement, interest and penalties of over $28 million. See “SEC Enforcement Action Involving ‘Broken Deal’ Expenses Emphasizes the Importance of Proper Allocation and Disclosure,” The Hedge Fund Law Report, Vol. 8, No. 27 (Jul. 9, 2015).

In response to these actions, said Borrelli, many firms are scrutinizing their allocation procedures. In addition, there is uncertainty about whether certain expenses can ever be charged to a fund, regardless of how clear the disclosure is.

Borrelli described the challenge of devising policies and procedures that are “fair, but also realistic.” For example, in practice, a firm may not be able to allocate broken deal expenses to co-investors in some transactions, because they may not yet have signed on to the deal. Another consideration is that the funds to which such expenses are charged benefit from the participation of co-investors. Thus, it may be fair to charge the fund, even if it is not practical to charge co-investors.

Clear disclosure of the policy behind such allocations may be satisfactory.

Not only must a firm have policies and procedures governing fees and expense allocations, added Borrelli, but those policies must be specific; the phrase “including without limitation,” he said, is not a “silver bullet” that gives the manager carte blanche. At a minimum, a manager should disclose each category of expense that will be charged to a fund, including examples. He noted that such disclosures are typically contained in the fund’s private placement memorandum (PPM), in the fund’s partnership or operating agreement and in the adviser’s Form ADV. Because the SEC often compares the Form ADV to the fund’s PPM, it is essential to check all those documents for consistency.

Wegrzyn added that the SEC has broadened its interest in expense allocations to include hedge fund practices. It is looking at travel-related expenses, insurance premiums and compliance with caps on organizational and operating expenses. For more on expense allocations, see “Battle-Tested Best Practices for Private Fund Expense Allocations,” The Hedge Fund Law Report, Vol. 7, No. 38 (Oct. 10, 2014).

Compliance Resources

The SEC, said Wegrzyn, continues to stress the importance of tone from the top and culture of compliance; it expects senior management to lead by example and understand and comply with the company’s rules and regulations. He quoted Steven Cohen of SAC Capital, who apparently said, “I’ve read the compliance manual, but I don’t remember exactly what it says.” This signaled to the SEC that “compliance was not a top priority” for the firm, noted Wegrzyn.

While it is unclear whether there has been an increase in enforcement actions for minor violations as a result of Chair White’s “broken windows” approach to enforcement, Wegrzyn noted that, although its staff considers all rules to be important, the SEC continues to conduct risk-based examinations, focusing on
Wegrzyn noted that the SEC may return to a firm after concluding an exam to conduct a corrective action review to ensure that remedial work has actually been done.

CCO Liability

Borrelli observed that the SEC has the power and tools to charge a CCO in “pretty much any case in which something goes seriously wrong.” He cited the recent debate between Commissioners Aguilar and Gallagher on the issue, noting that both Commissioners will be leaving the SEC. See “SEC Commissioner Issues Statement Supporting Hedge Fund Manager Chief Compliance Officers,” The Hedge Fund Law Report, Vol. 8, No. 28 (Jul. 16, 2015); and “Commissioner Gallagher’s Dissent in SEC Enforcement Action Against Hedge Fund Manager Misses the Mark,” The Hedge Fund Law Report, Vol. 8, No. 30 (Jul. 30, 2015).

Chair White believes that CCO liability is appropriate in many instances but has also stated, “We do not bring cases based on second guessing compliance officers’ good faith judgments, but rather when their actions or inactions cross a clear line that deserve sanction.” Unfortunately, said Borrelli, it is not clear where that “clear line” lies.

According to Borrelli, Andrew Ceresney, director of the Division of Enforcement, has indicated that holding a CCO liable would be appropriate if that CCO engaged in misconduct, helped to mislead regulators or simply “wholly failed” to carry out his or her duties. That third circumstance, noted Borrelli, suggests that a CCO could be open to liability simply for doing a “really, really bad job.” He believes more guidance on the issue is needed. Failing to escalate a matter, failing to follow up on a matter and having multiple roles at a firm could result in CCO liability.

Reading between the lines of recent enforcement actions, Borrelli also thinks that the SEC might take action against a CCO if that CCO fails to act to avoid hindering a rainmaker, as in the BlackRock action discussed above. In Schwartz’ view, the biggest
departure from prior SEC practice is that CCOs have been named in cases even when there has been no harm to investors. Wegrzyn said that a key takeaway for advisers is that compliance testing should be ongoing, not just part of an annual review. The SEC expects CCOs to identify and act on issues throughout the year.

Borrelli said that there are more cases against single-hatted CCOs than against general counsels (GCs) because cases against CCOs are easier. The CCO is responsible for compliance with federal securities laws; a CCO’s negligence may support liability. In contrast, in a case against a GC, the SEC may have to prove actual misconduct on the part of the GC. He added, however, that some SEC Commissioners have publicly stated that the SEC should look at GC liability in the same way that it looks at CCOs.

Technology

In Wegrzyn’s experience, SEC exam staff asks about a firm’s compliance resources and the technology it uses to facilitate compliance. CCOs, he said, have so many duties that it is difficult to keep up with day-to-day compliance tasks without using technology. This is especially true for firms that are active traders or that manage multiple accounts. He cautioned that the SEC pays attention to trade allocation, noting that there are automated systems that allocate trades using funds’ investment guidelines and operating restrictions and maintain an audit trail for those allocations.


In another action involving deficient technology, trade monitoring systems used by Citigroup Global Markets, Inc. (CGMI) failed to identify over 467,000 trades that were routed through an affiliate over a 10-year period. Although CGMI personnel looked for compliance issues on a daily basis, the reports they received inadvertently omitted those trades. CGMI was fined $15 million and retained a consultant to improve its trade monitoring systems. See “Failure to Regularly Audit Compliance and Surveillance Systems May Carry Significant Consequences,” The Hedge Fund Law Report, Vol. 8, No. 33 (Aug. 27, 2015).

A third case involving technology concerned OZ Management, LP, which inadvertently provided inaccurate trade data about long and short positions to four prime brokers. Wegrzyn noted that long and short positions can vary across portfolio managers and prime brokers. In some cases, that firm identified trades as long or short based on the position at a particular prime broker, rather than its fund-wide position. It also showed some long positions as being short positions. This system failure went on for about six years, resulting in a $4.25 million penalty and disgorgement of over $243,000. See “SEC Settlement Suggests that Hedge Fund Managers Have Responsibility for Counterparties’ Reporting Obligations,” The Hedge Fund Law Report, Vol. 8, No. 29 (Jul. 23, 2015).

Schwartz said that it is becoming more common for advisers to use automated systems to obtain real-time data for compliance purposes. The latter two actions illustrate that a firm’s compliance department must identify and mitigate the risk of errors in its automated systems; a firm should test those systems and document that testing.