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CONFLICTS OF INTEREST

The SEC's Broken Windows Approach: Conflicts of Interest and Expense Allocation Concerns for Hedge Fund Managers (Part One of Two)

By Jennifer Banzaca

Pursuing its "broken windows" approach to enforcement, the SEC continues to scrutinize hedge fund managers. Accordingly, managers must be ever cognizant of SEC enforcement trends and practical lessons that may be gleaned from them. In connection therewith, The Hedge Fund Law Report recently interviewed Barry P. Schwartz, founding partner of ACA Compliance Group (ACA); Kent Wegrzyn, managing director of ACA; and Mark Borrelli, a partner at Sidley Austin. This article, the first in a two part series, sets forth the participants' thoughts with respect to the SEC's broken windows approach, conflicts of interest and allocation of fees and expenses. In the second installment, the interviewees will discuss compliance resources, chief compliance officer (CCO) liability and technology.

On Thursday, October 1, 2015, from 11:00 a.m. to 12:00 p.m. EDT, Schwartz, Wegrzyn and Borrelli will expand on the topics in this series – as well as other issues that affect hedge fund managers – in a webcast entitled "What Hedge Fund Managers Need to Know about SEC Enforcement Trends," which will be moderated by William V. de Cordova, Editor-in-Chief of the HFLR. To register for the webcast, click here. For more from ACA, see "*ACA Compliance Professionals and SEC Veteran John H. Walsh Share Insights on SEC Priorities for 2015*," The Hedge Fund Law Report, Vol. 8, No 16 (Apr. 23, 2015); and "*ACA Compliance Group Clarifies Misconceptions Commonly Held by Fund Managers with Respect to Cybersecurity*," The Hedge Fund Law Report, Vol. 8, No. 15 (Apr. 16, 2015).

Broken Windows Approach Generally

HFLR: Chairman White gave her broken windows speech in late 2013, indicating that the SEC would target minor rule violations in the conviction that unchecked minor violations could lead to major violations. In that time, has the industry witnessed changes with respect to the SEC's approach to enforcement?

Borrelli: I don't think that the changes have been quite as dramatic as people thought they might be, but there definitely have been changes that people have noticed. If you look at the cases the SEC has brought in the last year or two, you will definitely see some cases that may not have been brought previously.

Wegrzyn: I agree with Mark and would also point out that the Division of Enforcement filed a record number of enforcement actions in fiscal year 2014. They brought 755 cases compared to 686 in 2013. The Enforcement Division now seems more willing to pursue what some may characterize as minor rule violations. For instance, last year they brought cases against individuals and companies that failed to file certain forms – like Schedule 13D and 13G – in a timely manner.

HFLR: The broken windows approach hinges on the theory that prosecuting minor violations has major compliance benefits. If the SEC has been pursuing an increasing number of enforcement actions for minor rule violations, has there been a corresponding decrease in major compliance violations in the market? In other words, has the broken windows approach been effective?

Borrelli: I think there's some question as to whether the analogy ever worked in the first place. The broken windows approach was something that was developed to address criminal conduct in New York City, and there is a question as to whether that applies to an industry that was already heavily regulated and that has the vast majority of its participants trying to comply with the law. That said, it's hard to measure whether there has been a decrease in major compliance violations as a result. People are more concerned about minor violations, but that doesn't necessarily translate to them being less likely to commit major violations.

HFLR: Has the broken windows approach to enforcement had any unintended consequences?

Schwartz: There are certainly instances where the SEC has identified firms or individual CCOs through enforcement action because of major compliance violations, but it's possible these firms and CCOs were doing all of the little things correctly to avoid being targeted in this broken windows approach. Maybe their compliance with the cash solicitation rule was perfect, but they missed a bigger fraud going on within the firm.

Wegrzyn: Some people have wondered whether the SEC's focus on these smaller deficiencies would cause them to miss some of the bigger violations. One thing we have noticed is that the SEC has significantly increased their resources in technology and they've developed tools to help them be more efficient in their exam process, such as the National Exam Analytics Tool.

Conflicts of Interest

HFLR: What are some of the most dangerous areas for conflicts of interest? In other words, where are the largest pitfalls for hedge fund managers, and how can they avoid them?

Borelli: I think the biggest area of danger has to be any undisclosed fees or compensation the manager receives as a result of the fund's resources. That will always be a big focus of the SEC. So, the first step is just making sure you properly disclose any such arrangements.

Wegrzyn: Another conflict of interest I know the SEC is interested in is the allocation of investment opportunities, especially in circumstances where a hedge fund manager may be managing multiple private funds and/or separate accounts. The SEC wants to make sure there are fair and equitable allocations to all clients. Certain managers may have a lot of internal capital invested in one particular hedge fund, and the SEC wouldn't want to see that manager favoring or making allocations to that vehicle over the other vehicles. Having proper policies, procedures and disclosures is important in this area.

Schwartz: There are clearly conflicts related to the personal activities of the investment professionals and all staff at a manager – whether they be personal trading; outside business activities; political contributions; or access to and use of material nonpublic information stemming from personal or family relationships.

HFLR: What steps can a hedge fund manager take to solve conflicts of interest issues? Is the solution simply a matter of disclosure of the conflict to investors (i.e., does disclosure act as a panacea that can cure most conflicts)?

Schwartz: Everything is premised on disclosure. That said, there is great value in being consistent with the practices of the industry. While you may be within the four walls of the law by disclosing certain practices, avoidance is sometimes just as good as proper disclosure. For example, while principal transactions are permitted with disclosure and consent under the Investment Advisers Act of 1940, many managers try to avoid them wherever possible because of the optics. Despite following Section 206, the rules under Section 206 and the SEC staff guidance, there are still the optics of engaging in a principal transaction where you're selling an asset to the fund. It's just so far outside of industry accepted practices that managers choose to avoid it whenever possible.

HFLR: In recent months, the SEC has taken enforcement action against investment advisers for conflicts of interest, even when there is no material financial harm to investors (e.g., the settlement with Stilwell Value LLC). [See "*SEC Settlement Emphasizes the Importance – and Limits – of Fund and Transaction Disclosure*," The Hedge Fund Law Report, Vol. 8, No. 13 (Apr. 2, 2015).] How can a manager cure a conflict of interest violation that doesn't cause any harm to investors?

Borrelli: Disclosure, even after a particular transaction has already occurred, can sometimes go part of the way toward curing the violation if there is no material harm. There are other things you could do, such as give investors some option they didn't previously have regarding their investment. It's easier to cure a conflict where you have a fund that allows regular redemptions; it's more difficult if investors can't get out.

HFLR: Some of the recent SEC Enforcement actions have imposed very stiff penalties – more than tens of millions of dollars in several cases – on firms for conflicts of interest violations. For instance, Guggenheim Partners Investment Management was ordered to pay civil money penalties of $20 million. [See "*SEC Settlement with Investment Adviser Highlights Perils of Undisclosed Conflicts of Interest*," The Hedge Fund Law Report, Vol. 8, No. 33 (Aug. 27, 2015).] Are these large penalties driven simply because of the size of the parties in question, or can an inference be drawn from them as to the relative importance of conflicts of interest to the SEC?

Schwartz: Clearly, the size of the financial penalty is tied to the ability of the respondent to have the resources to pay it; you can't get blood from a stone. If the money is not there, you're simply not going to get it. I would argue that the more severe penalty to the firm is the reputational penalty.

For example, a $200,000 fine may be small compared to the size of the fund or the assets under management by a particular manager, but the ability of the individuals involved in that conflict or their failure to eliminate conflicts of interest could be career changing. The violations could impact the ability of these people to continue to work, and it creates a liability for them. Who would hire the CCO who recently left his firm after being charged by the SEC, no matter how small the penalty was?

Borrelli: I think there is some connection between the size of the penalties and the importance the SEC has placed on conflicts of interest. The size of the institution certainly factors into the size of the penalty. To a certain extent, I think there is a message being sent with regard to conflicts and the penalties we've seen for violations.

Allocation of Fees & Expenses

HFLR: In Alpha Titans, the SEC charged not only the offending investment adviser and its affiliates, but also the outside auditor that signed off on the fund's audited financial statements. [See "Inadequate Disclosure of Expense Allocations May Carry Unintended Consequences," The Hedge Fund Law Report, Vol. 8, No. 19 (May 14, 2015).] Is this a trend – where the SEC expands its focus beyond the main party in question and pursues actions against service providers and other parties – that is expected to continue?

Borrelli: I think it is a trend and evidence of the mentality that the outside professionals are "gatekeepers." Last year, you saw cases against the chairs of audit committees when you might not have seen those in the past. We've seen cases against CCOs. Commissioner Stein wondered out loud whether the SEC should review the role of lawyers and whether they can help prevent fraud.

There is definitely a focus on third parties, and the SEC takes the view they are very important in trying to prevent fraud. If they see a third party that had the opportunity to prevent fraud or some other violation, and they think they can prove the third party violated securities laws by failing to prevent the violation, the SEC has shown that they will bring those cases.

HFLR: Alpha Titans also saw the GC charged, barred from the securities industry for a year and suspended from practicing as an attorney on behalf of any SEC-regulated entity for one year. While there has been a lot of discussion in the industry lately about the SEC's focus on CCOs, should we expect a similar focus on GCs as well?

Borrelli: I think you can expect that trend to continue, and that is what Commissioner Stein has suggested. While the positions of the other commissioners are not always clear, the trend does seem to be that there's going to be more scrutiny of third parties, and lawyers are not exempt from that.

Schwartz: Based on the actions of the SEC we've seen this past year, we know there is a great deal of focus on CCO liability. The GCs are feeling just as great a sense of that liability as the CCOs right now. I don't think the GCs are expecting any amount of shelter that the CCOs don't have. The GCs feel like they are invested in protecting the firm in the same way the right now.

HFLR: Many private equity managers registered as investment advisers pursuant to Dodd-Frank. While adjusting to the increased regulation to which they are now subject, are newly registered PE managers prone to enforcement action as they have to reconcile past practices (such as with respect to expense allocation) with the new regulatory regime (which may prohibit such allocation practices)?

Borrelli: I think you have seen that with private equity managers who were not registered and used to dealing with very sophisticated investors. A lot of those firms had long-standing practices that, in their view, were pretty well understood and accepted in the industry. They sometimes took the view that investors in their industry knew what the practices were and they ran into a different view on the part of the SEC, specifically that, even if you think investors understand your practices, you still need clear disclosures.

There definitely has been some adjustment because of the difference in expectations, in terms of the way people had been operating for many years and the regulatory environment that now surrounds a regulated investment adviser.

HFLR: If an investment adviser wants to allocate its internal expenses to its funds and products, what practices should it follow to effectively do so without encountering issues similar to those that have plagued the subjects of recent SEC enforcement actions?

Borrelli: Clear and detailed disclosure is the biggest thing. As a general rule, the less common a practice is, the more detailed the disclosure should be.

You should also be testing against the disclosure. For example, if an adviser tells investors it is going to allocate expenses in a certain way, someone has to test to be sure the expenses are actually being allocated in that way. A lot of times, the people involved in preparing the disclosure are not the same people who are actually making the allocations, so there may have been changes to the disclosure that don't necessarily reflect what's actually being done. There are a number of reasons that your practices could deviate from your disclosures, so testing is important.

Wegrzyn: Not only is disclosure critical, but it's also very important that disclosure is consistent across the board – in the governing documents, the Form ADV disclosure and any other materials. I think this is especially true if there are any internal or overhead expenses of the manager being passed on to the fund. I also think the SEC examination staff would expect hedge fund managers to conduct some sort of benchmarking analysis to ensure the rates or fees they are charging for those particular services are competitive and reasonable. It would also be important to maintain appropriate documentation of this benchmarking analysis.

Schwartz: We've seen managers sued this year for practices they engaged in almost 10 years ago. While disclosure is important, meticulous recordkeeping is also important. You want to have the documentation be able to stand on its own, without any explanation, because it's one of those things that will ultimately save a firm when they have to look back as far as some of these enforcement cases have. We tell our clients that, however much documentation they have about how they're allocating expenses – especially if it's off-market – they need to document more because that will save them in the future.

