Examinations

SEC to Seek Third-Party Confirmation of Investor Assets Held by Regulated Firms

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By HFLR Editor, *Hedge Fund Law Report*

As part of its endeavor to increase enforcement efforts in response to the Bernard Madoff and other investment scandals, the SEC examination staff plans to seek third-party verification of investor cash and securities held by investment advisers and other regulated entities.

In March 9, 2009 letter to Managed Funds Association (MFA), the hedge fund trade association, and the Investment Adviser Association (IAA), Gene A. Gohlke, Associate Director of the SEC's Office of Compliance Inspections and Examinations, said that in "recent months," his staff has decided that to verify assets, it will have to request independent confirmation of investor assets from various third parties. In his letter, Gohlke told the MFA that to confirm the existence of assets managed by the adviser being examined, the staff may contact the following individuals and entities: bank and broker-dealer custodians; account administrators; investors in hedge funds managed by the adviser; advised clients; derivative counterparties; hedge fund administrators and/or managers that are invested in by advised clients; National Securities Clearing Corp., Depository Trust & Clearing Corp.; and auditors for the advisory firm and/or investor accounts.

In its requests, the SEC examination staff will seek confirmation from third parties of cash and securities held by certain advised clients as of a specific date and for transactions in such accounts over a period of time. In requesting confirmations from advisory clients, the examination staff will ask clients to confirm that their account balances as of a specific date were consistent with their records and that they authorized contributions to and withdrawals from their accounts over a period of time. Finally, in requesting confirmations from investors in hedge funds managed by registered advisers, the staff will request that such investors confirm that their capital account balances, as shown by the funds' records, remain consistent with the investors' records.

Gohlke assured MFA that it should not view the account confirmation requests as an indication by the agency or by its staff that unlawful conduct has occurred, or that it evinces an "adverse reflection" on the firm or its associates. The examinations, Gohlke noted, will remain non-public, as will the staff's communications with the unaffiliated entities. Gohlke requested that MFA and the IAA inform their respective members of this examination practice.

A Departure from Prior Practice

The letter is a significant departure from prior practice, and is at least in part a response to the criticism that earlier practices failed to detect and prevent Bernard Madoff's $50 billion Ponzi scheme, Robert Allen Stanford's investment fraud and similar schemes. For an account of the reactions, see "Senate Banking Committee Grills Regulators on Missing Madoff, Discusses Possibility of Requiring Investment Advisers to Keep Assets at Independent Custodians," Hedge Fund Law Report, Vol. 2, No. 6 (Feb. 12, 2009).

Reflecting a widely-shared sentiment, Katherine C. Donlon, an attorney with Florida law firm Fowler White Boggs P.A., told the Hedge Fund Law Report, "for the SEC to go out and contact clients and counter-parties would certainly be a departure from current procedure. I do not know whether an argument could be made that it exceeds the agency's statutory mandate, but I do think that in the present regulatory and political climate it is unlikely that argument would go very far."

The statutory mandate referred to by Donlon is contained in Section 206(4) of the Investment Advisers Act of 1940 (Advisers Act), which authorizes the SEC to "prescribe means reasonably designed to prevent such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative." Under that authority, the SEC in 2004 promulgated Advisers Act Rule 206(4)-7, known as the compliance rule, which effectively brought the level of compliance for registered advisers up to the level required for broker-dealers. For earlier developments under that rule, see "SEC to Issue Standardized Examination Letter," Hedge Fund Law Report, Vol. 1, No. 8 (April 22, 2008).

Impact of Letter

For hedge fund managers, the Gohlke letter raises at least five questions:

1. What will the staff do if they discover a discrepancy between the records of the registered adviser under examination and the records of a third party?
2. Will the new practice entail SEC staff involvement in the valuation of assets?
3. Will the SEC be satisfied with a report from a reputable auditor, or will it in effect re-do the auditor's work?
4. As long as U.S. law allows some advisers to remain unregistered, will this practice have an impact on the choice to register or not?
5. Under existing law, especially the Freedom of Information Act (FOIA), 5 U.S.C. § 552, can the SEC prevent public discovery of its communications with unaffiliated entities?

Likely SEC Reactions to Discrepancies

What will be the likely reaction if the compliance office contacts a third-party source and there is a discrepancy between that source's records and those of the registered adviser?

Adam Gale, Of Counsel at Orrick, Herrington & Sutcliffe LLP, suggested that in such a scenario, "if it's a small discrepancy, then in most cases the examiner will most likely just ask for an explanation, as it probably reflects a minor bookkeeping error. If it is a larger discrepancy, then the SEC will probably expand its inquiry."

Valuation

Perrie M. Weiner, International Co-Chairman of DLA Piper's securities litigation practice, explained that the letter should be considered in the context of other recent developments, such as the SEC's promulgation of Rule 206(4)-8 under the Advisers Act. Under that rule, even negligent misrepresentations by advisers to pooled investment vehicles can form the basis of SEC enforcement actions alleging fraud. Accordingly, valuation is an area in which hedge fund managers need to be particularly careful to avoid even negligent misstatements. As Weiner said, "it is a reasonable inference that they are going to be looking into all material communications between the investment adviser and its investors, including representations concerning account balances, adviser compensation, fund performance and net asset values particularly in the context of hard to value illiquid securities, among other things. And, under this particular rule, even negligent misrepresentations may become the basis for an SEC enforcement action."

A Re-audit of the Audit?

Will the SEC review ground that a reputable auditor has already covered? Probably not. According to Weiner, "there is a limitation as to the ground that the SEC can cover," and in light of the SEC's limited staff, they would be unlikely to reproduce work already conducted by a reputable auditor. Gale, of Orrick, seconded that view: "If the auditor is a very well-known auditor, and if the auditor has already obtained documents from the brokers and custodians, which may not always be the case, then the SEC will probably not be inclined to re-do the work the auditors will have done for them. On the other hand, auditors will not have contacted investors for information."

Of course, the question then becomes which auditors, in the eyes of the SEC, count as reputable?

An Adviser's Willingness to Register

There are at least three benefits to a hedge fund manager of registering with the SEC, even if it is not required. First, registration has marketing benefits – it enables a manager to plausibly claim that it operates with the imprimatur of the SEC. Second, many managers expect a new registration requirement somewhere down the line, and would like to do so on their own schedule, before they are forced. Third, some managers expect to launch 15 or more vehicles that would count as clients under the *Goldstein* case.

There are also various reasons to avoid registration if possible, chief among them, avoiding random compliance inspections and examinations. Gohlke's letter appears to lend more weight to the anti-regulation camp. As Gale suggested, no investor wants to receive a communication from the SEC asking about their adviser, nor do advisers want their investors to receive such communications. The SEC may well assure both parties that the communications are not intended to reflect adversely on the manager, but that strikes many market participants as cold comfort.

Weiner said that as long as there is a choice facing a particular adviser as to whether or not it should register, the prospect of this expansion of the SEC's examinations of registered advisers will tilt many of them against doing so.

Freedom of Information Act

Hedge fund managers generally prefer to keep their proprietary information on positions and strategies non-public. For expressions of this concern, see "The Freedom of Information Act: A Crack in the Confidentiality of Disclosed Short Sale Data?" Hedge Fund Law Report, Vol. 1, No. 28 (Dec. 16, 2008).

The Freedom of Information Act (FOIA) is designed to permit members of the public to request data that would otherwise remain non-public. It provides nine exemptions under which a covered agency such as the SEC has the authority to withhold information, including an exemption for "trade secrets and commercial or financial information obtained from a person and privileged or confidential."

One of the key precedents in understanding the scope of this exemption as applied to government agencies in the financial context is a 1996 decision by the Second Circuit, *Nadler v. Federal Deposit Insurance Corporation*, 92 F.3d 93 (2d Cir. 1996). Jerrold Nadler, the Representative for New York's Eighth District, and other plaintiffs demanded the disclosure of redacted portions of a joint venture agreement that provided for the development of two parcels of land in the Tribeca neighborhood of Manhattan. The FDIC had become a party to this joint venture agreement in 1992, when it became the receiver for a bank that had been one of the original parties thereto.

Both the trial court and the Second Circuit found that the FDIC was entitled to invoke the exception for "trade secrets and commercial or financial information" in order to avoid disclosing "descriptions of the joint venture's plan to develop the subject property . . . statements of ownership percentages for various aspects of the commercial venture as agreed to between the joint venture partners . . . budgets and cost estimates . . . terms of agreements for cost-sharing or the payment of expenses . . . estimated values . . . [and] options provisions and terms governing the [parties'] rights to elect other courses of action for project development."

Jeffrey Buss, a partner at Smith, Buss & Jacobs, LLP, represented Nadler in that litigation. He reviewed Gohlke's letter for the Hedge Fund Law Report. "I think that the SEC will be able to keep the information exempt from disclosure under the Freedom of Information Act. When you look through the precedents, including *Nadler* – when the agencies have invoked the trade secrets exemption the courts have been very reluctant to compel disclosure."

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