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Chief Compliance Officers

Top SEC Officials Discuss Hedge Fund Compliance, Examination and Enforcement Priorities at 2014 Compliance Outreach Program National Seminar (Part Three of Three)

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By Jennifer Banzaca, *Hedge Fund Law Report*

On January 30, the SEC hosted the 2014 edition of its annual Compliance Outreach Program National Seminar for senior professionals at hedge fund managers and other investment advisers. Panelists at the seminar included senior SEC officials and CCOs from hedge and private equity fund managers. The seminar provided candid insight from regulators and conveyed best practices developed in the private sector. This is the third article in a three-part series summarizing the more noteworthy points made at the seminar. This article covers: compliance considerations specific to the private equity industry; best practices in fair value pricing; due diligence on pricing services; CCO liability; and outsourcing of compliance functions.

The first article in this series discussed SEC Chairman Mary Jo White's opening remarks and detailed the compliance, examination and enforcement priorities outlined by the heads of relevant SEC divisions. And the second article detailed SEC priorities by theme and by SEC division and relayed insights on nine topics of specific interest to private fund advisers: presence examinations, risk assessments, conflicts, co-investments, allocation of expenses, marketing, custody, allocation of investment opportunities and broker-dealer registration.

Private Equity

Barbara Burns, Partner and General Counsel at AEA Investors LP, cited the expanding range of laws and regulations to which private equity fund managers are subject, and the consequent expansion of the typical private equity CCO's portfolio of responsibilities: "We're not only subject to SEC regulation but also to CFTC regulation and a whole host of European regulators that are now taking a broad interest in alternative investments. So, I think the job of the CCO of a private equity fund has fundamentally changed."

Igor Rozenblit, a Private Equity Specialist in the Asset Management Unit (AMU) of the SEC's Division of Enforcement, then identified various areas of concern for enforcement professionals in connection with private equity fund structures and documents: "On the fund structure side, we're seeing very broadly written LPAs with vague language, especially around fees and

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expenses. We see few information rights for limited partners. We see high barriers to action for disgruntled limited partners and one of those is that you can't take your money back; you can't vote with your feet." Rozenblit also noted that regulators are concerned about the continued collection of management fees on funds that are effectively no longer investing. "This is actually a decent time for capital raising," Rozenblit said, "but still there are many advisers out there who are managing capital who really see no future for themselves as investments advisers. They can't raise any more money and their funds turn into zombies. That changes their incentives a little bit."

Next, Rozenblit discussed the AMU's concerns around fees and expenses. In particular, Rozenblit identified two potentially problematic methods by which fees that should be borne by the management company are shifted to the funds (more specifically, to the limited partners in the funds) – payment of operating partner salaries by the funds and insufficiently disclosed automation. On the former, Rozenblit noted, "We're seeing advisers taking expenses out of the adviser that have traditionally been part of the adviser and moving them over to the funds. This manifests itself in a lot of creative ways, such as the use of operating partners or senior advisers who appear to investors to be part of the adviser. As such, it would be logical to assume their compensation would be part of the management fee, but they are actually consultants to the funds and they are paid by the funds or portfolio companies." See "SEC Order Suggests That Private Fund Operating Expenses Should Be Allocated Based on Line-by-Line Determinations Rather Than an Across-the-Board Percentage Split," below, in this issue of Hedge Fund Law Report. On the latter, Rozenblit stated, "Generally, automation is a great thing because an adviser's process ends up getting faster, but the limited partners pay for the software and other costs associated with it. There is nothing wrong with the limited partners paying, as long as it is disclosed."

Rozenblit also cited two categories of fees that may be problematic in the absence of sufficient disclosure – monitoring fees and accelerated fees. "These are really outside most people's understanding of how private equity fees are supposed to work. Fees such as monitoring fees and fee accelerations are concerning because a large number of limited partners don't know what they are or that they are happening. When we see such fees, it is reasonable to assume there is a breakdown in disclosure."

Valuation has, for some years, been a headline concern for regulators in the hedge fund industry. See "RCA Symposium Offers Perspectives from Regulators and Industry Experts on 2014 Examination and Enforcement Priorities, Fund Distribution Challenges, Conducting Risk Assessments, Compliance Best Practices and Administrator Shadowing (Part Three of Three)," Hedge Fund Law Report, Vol. 7, No. 1 (Jan. 9, 2014). In the private equity industry, Rozenblit noted, one specific aspect of the valuation process that has garnered regulators' attention relates to interim valuations. "Interim valuations really represent the most recent and relevant track record to your future and potential investors," he said. "When someone is doing due diligence on your fund, the companies that are valued by the adviser happen to be the most relevant to the due diligence process. Interim valuations are a pretty good and easy way to communicate to your limited partners about your portfolio. That kind of information really guides the due diligence process of the limited partners when looking at your next fund." See "How Can Hedge Fund Managers Market Their Funds Using Case Studies Without Violating the Cherry Picking Rule? (Part Two of Two)," Hedge Fund Law Report, Vol. 6, No. 47 (Dec. 12, 2013). (Valuation is discussed more fully below.)

Rozenblit also highlighted the importance during examinations and enforcement actions of a competent, knowledgeable CCO that understands the business, its investment process and its actual investments. "It's very confidence building when I'm in an examination and the CCO really

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knows a lot about his or her business," Rozenblit said. "Such a CCO can explain how the business works, how the various processes work and the genesis of various investments. When we see that, we can relax. The only way to really have that is to have the CCO integrated with the actual business."

Finally, Burns, of AEA, explained part of the rationale for the relative absence of advertising by private equity fund managers following passage of the JOBS Act rules. "No one wants to be the first to be examined and scrutinized for the significant compliance component that is required to take advantage of Rule 506(c)," Burns said. "I think everyone needs to think about what it means to truly develop a compliance program; truly understand who constitutes an accredited investor and how to develop records relating to the accredited status of investors; and think through all of the important compliance elements required to adequately rely on the JOBS Act. Private equity fund managers also need to understand the harmonization of SEC and CFTC rules, and the overlay of the AIFMD. For these and other reasons, we're all a little hesitant."

Valuation

Matthew O'Toole, Senior Special Counsel with the National Exam Program in the SEC's San Francisco Regional Office, noted that for hedge and private equity fund managers, valuation practices should be specific to assets and investment strategies rather than generic. "We see valuation as an essential area for you to address in your risk-based compliance programs," O'Toole said. "There is no one-size-fits-all approach to valuation or precise formula that answers every valuation question. You have to look at common industry valuation techniques and practices and see what fits in with your business model and the assets in which you invest."

Sarah ten Siethoff, Senior Special Counsel with the Division of Investment Management, then noted that valuation should be an interactive process between the board of a fund and its investment adviser. "While the board ultimately has responsibility in this area, advisers are expected to provide the board with enough information to provide proper oversight." For registered investment companies, ten Siethoff continued "there is a much more specific framework under the Investment Company Act of 1940. The required practice is that you use market prices, if available, for valuing portfolio securities. If market prices aren't available, use fair value, which is the price you reasonably expect to receive in a current sale." See "WilmerHale and Deloitte Identify Best Legal and Accounting Practices for Hedge Fund Valuation, Fees and Expenses," Hedge Fund Law Report, Vol. 6, No. 28 (Jul. 18, 2013).

Fair Value

Jaime Eichen, Chief Accountant in the Division of Investment Management, said that in cases where managers are required to fair value an asset, they should do so using the GAAP definition of fair value, which generally provides that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly, arms length transaction between market participants. Leo Chan, Senior Specialized Examiner with the National Exam Program in the SEC's San Francisco Regional Office, advised that fair value should be measured using valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs.

Jeffrey Blockinger, Chief Legal Officer and CCO at Och-Ziff Capital Management Group, highlighted the unique challenges posed by so-called level two assets, and suggested a few techniques for increasing the precision of valuation of such assets. "On an absolute basis, level

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three assets are more risky, but when it comes to valuation, the complexity of level two assets could make it more difficult to get it right. Things managers can do to mitigate the risks in valuing these securities include obtaining more than one quote, and assessing the quality of the quote coming in and the relationship between the person giving the quote and the individuals at your firm." Blockinger continued, "What firms can do to mitigate these risks will be based on the types of securities in your portfolio, the internal processes you have and the internal infrastructure you have. Looking at those things will allow you to get to a place where you understand how to develop reasonably tailored policies and procedures to help you get valuation right." See "DLA Piper Hedge Fund Valuation Webinar Covers Fair Value Methodologies, Valuation Services, Valuing Illiquid Positions and Handling Valuation Inquiries During SEC Examinations," Hedge Fund Law Report, Vol. 6, No. 31 (Aug. 7, 2013).

Pricing Services

Pricing services can be useful in ascertaining the value of illiquid assets, but SEC officials cautioned that the responsibility for valuation remains with the board of a fund and its manager. Generally, in retaining a pricing service, managers should perform due diligence on the pricing service's process; the inputs and assumptions in its models; the backgrounds of its principals; its disaster recovery and business continuity plans; its technology infrastructure generally; and the experience and qualifications of the specific personnel performing the valuation. Eichen advised, "Don't blindly rely on the prices provided without performing adequate due diligence on the methods, models, inputs and assumptions use by the pricing service firm. Management needs to get involved and understand the prices you're getting. Also, remember that the board is ultimately responsible for determining fair values. They need to be sure a price provided by a valuation service is the fair value of the security. Before the board decides to use evaluated prices from a pricing service, it should understand the methods, inputs and assumptions used in making that valuation and how those will be affected if market conditions change."

Eichen also suggested that managers have in place a policy and procedure for challenging prices provided by a pricing service. The process should: outline a specific procedure for challenging prices (including timing); identify who has standing to challenge prices; specify the circumstances under which prices provided by the pricing service may be changed; and indicate whether and how such changes will be memorialized.

Examinations

Chan noted as follows with respect to examinations focusing on valuation: "We're looking at the valuation process and internal controls to identify any potential deficiencies. We will review written valuation policies and procedures to assess if they are sufficient and reasonable. We want to see if the valuation personnel have the proper experience and background to do valuations. We will look at sample valuations to see if the method is consistent with the policies and procedures. And we will look to see if valuations are performed in a consistent manner – and, if they are not, why not."

Chief Compliance Officers

Echoing a point made by Rozenblit, cited earlier in this article, Mark Dowdell, Assistant Director of the National Exam Program in the SEC's Philadelphia Regional Office, stated, "We want to see a CCO who has the ability to correct problems and report those problems to management. That

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person must have access and transparency across the board in the firm. We want the CCO to be knowledgeable. You have to have the expertise to do the job. You must learn and know the '40 Act, the rules and regulations and the various releases and no-action letters that we utilize as guidance for the industry. You have to be a little cynical and look at something for the reasoning behind it." Dowdell further noted that, during the examination process, the SEC perceives the CCO as the regulator's main point of contact within the firm, primarily responsible for all information requests and for coordinating interviews.

Janet Grossnickle, Assistant Director in the SEC's Division of Investment Management, noted that the obligations of investment adviser CCOs generally derive from at least two sources: Rule 206(4)-7 under the Investment Advisers Act of 1940 (Advisers Act) and Rule 38a-1 under the Investment Company Act of 1940 (Investment Company Act).

Grossnickle explained Rule 206(4)-7 generally requires registered advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and related rules, to conduct annual reviews of the adequacy of those policies and procedures and to designate a chief compliance officer to supervise the compliance program. See "Who Should Newly Registered Hedge Fund Managers Designate as the Chief Compliance Officer and How Much Are Chief Compliance Officers Paid?," Hedge Fund Law Report, Vol. 4, No. 7 (Feb. 25, 2011).

Grossnickle said that Rule 38a-1 largely reproduces the requirements of Rule 206(4)-7, but also recognizes that funds have boards and independent directors who are responsible for approving the compliance program. Moreover, Grossnickle added that within the Investment Company Act and the rules thereunder, "there is an imbedded prohibition against any officer, director or employee of the fund, its adviser, distributor or anyone they can direct from taking any action to coerce, manipulate, mislead or fraudulently influence the CCO."

Chris Marzullo, General Counsel and Chief Compliance Officer of Brandywine Global Investment Management LLC, suggested that an investment adviser CCO's obligations can be divided into four categories: (1) facilitating compliance with federal securities laws by all employees of the firm; (2) educating the firm on the fundamental legal requirements applicable to the business; (3) advising the firm on the legal requirements and best practices in the industry; and (4) "drawing lines" when serious issues arise and ensuring those issues are addressed and resolved. "When you see something that should not go forward or you think needs further analysis, you need to put the brakes on and talk to senior management," Marzullo said.

CCO Liability

Judy Werner, Executive Director at the National Society of Compliance Professionals, stated, "I think people are overly concerned about having supervisory liability. The current administration at the SEC is not looking to find CCOs who are trying very hard to do their jobs and are doing them well. They don't have much to fear from the SEC. The uneducated CCO is going to be the weakest link. Things will go wrong at every firm, and it matters how you handle those things."

Marshall Sprung, Co-Chief in the AMU, noted that the SEC is not "out to get" CCOs. The SEC's compliance initiative has primarily focused on firms that: have ignored or insufficiently focused on identified deficiencies; that lacked effective or sufficiently customized compliance programs; or failed to conduct annual compliance reviews. See "How Hedge Fund Managers Should Approach Preparing For, Conducting and Documenting the Annual Compliance Review (Part Two of Two)," Hedge Fund Law Report, Vol. 5, No. 13 (Mar. 29, 2012). "From an enforcement perspective, compliance officers who perform their duties diligently, in good faith and in

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compliance with the law need not fear enforcement action. We view CCOs as critical gatekeepers in ensuring compliance with federal securities laws. We recognize their challenges. Many times, the CCOs we've pursued have worn other hats in the organization and those roles are more relevant to their culpability in the enforcement action. We have rarely sued an individual serving purely as CCO." See "Benefits, Challenges and Recommendations for Persons Simultaneously Serving as General Counsel and Chief Compliance Officer of a Hedge Fund Manager," Hedge Fund Law Report, Vol. 5, No. 19 (May 10, 2012).

Sprung identified the following common compliance failures at hedge fund managers discovered in the course of examinations: deficient or nonexistent compliance programs; policies and procedures that do not sufficiently address key aspects of the firm's business; "off the shelf" policies that are not adequately tailored to the risks or obligations of the firm; no annual review; no code of ethics; and recidivism. On the last, Sprung noted, "We've found cases where the CCO or firm was specifically warned by SEC exam staff or outside consultants about a compliance deficiency and it was not remedied or only partially addressed. This is an issue." See "Three Steps in Responding to an SEC Examination Deficiency Letter and Other Practical Guidance for Hedge Fund Managers from SEC Veteran and Sutherland Partner John Walsh," Hedge Fund Law Report, Vol. 7, No. 6 (Feb. 13, 2014).

One key consideration in determining whether a CCO may have supervisory liability is whether that CCO in fact has authority to supervise others. According to Grossnickle, "Having the title of chief compliance officer does not, in and of itself, carry supervisory responsibility over business people. You are not a supervisor because you provide advice on compliance or business issues or fix a problem." See "Recent SEC Settlement Clarifies the Scope of Supervisory Liability for Chief Compliance Officers of Hedge Fund Managers," Hedge Fund Law Report, Vol. 6, No. 33 (Aug. 22, 2013).

On September 30, 2013, the SEC's Division of Trading and Markets issued a set of frequently asked questions (FAQs) addressing the supervisory liability of compliance and legal personnel at broker-dealers and investment advisers. Some of the factors relevant in determining whether a CCO is considered a supervisor include: whether the CCO has been given or has assumed clear supervisory authority for business activities in the firm's policies and procedures or otherwise; whether the CCO has the ability to hire, reward or punish other employees; and whether the CCO knew that he or she was responsible for the actions of others. For more on the FAQs, see "What Do the SEC's Recently Released FAQs on Supervisory Liability Mean for Legal and Compliance Personnel at Broker-Dealers and Hedge Fund Managers?" Hedge Fund Law Report, Vol. 6, No. 41 (Oct. 25, 2013).

Outsourcing Compliance Functions

Some firms outsource the compliance function rather than assigning the function to an in-house CCO, or giving the CCO duties to an in-house person with an existing role (such as the GC, COO or CFO). See "Simon Lorne, Chief Legal Officer of Millennium Management LLC, Discusses the Evolving Roles, Challenges and Risks Faced by Hedge Fund Manager General Counsels and Chief Compliance Officers," Hedge Fund Law Report, Vol. 6, No. 37 (Sep. 26, 2013). One of the SEC's chief concerns in such outsourcing scenarios is whether the outsourced firm has sufficient time and resources to sufficiently oversee compliance at the client firm – especially in cases where the outsourced firm has many clients. As Werner noted on this point, "There is a concern that the outsourced CCO is not properly engaged and can't fulfill his or her responsibilities to the adviser if the outsourced CCO is overseeing 20 different managers. So, in outsourcing, you want to make sure the outsourced CCO does not have so many clients it cannot dedicate time to your

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firm. You should require that the CCO spend some time on site at your office to review your program, and there should be a good interface within the organization to provide information to the outsourced CCO."

Dowdell cautioned advisers to remember that outsourcing the firm's compliance obligations does not relieve the adviser of the fiduciary obligation to ensure adequate compliance. In keeping with this residual responsibility on the part of advisers, Dowdell advised managers to ensure sufficient engagement by the outsourced CCO in any retainer letter or similar document. "You need a tight agreement specifying what the outsourced CCO will work on. Will they spend time on site? Will they have someone on staff at the adviser to assist the outsourced CCO? These are things you have to consider." See "Ernst & Young's 2013 Global Hedge Fund and Investor Survey Describes Trends in Asset Sourcing, Alternative Mutual Funds, Customized Solutions, Staffing, Administrator Shadowing, Expense Pass-Throughs and Outsourcing," Hedge Fund Law Report, Vol. 6, No. 46 (Dec. 5, 2013).

Whether the CCO is in-house or outsourced, Werner concluded, "You need proper training and support to allow the compliance officer, any supervisors and other personnel to do their jobs. Remember, the untrained CCO is the weakest link in the firm."

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