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Allocation of Investment Opportunities

Hedge Fund Adviser Structured Portfolio Management Settles SEC Charges Relating to Improper Trade Allocations and Investor Disclosures

Sep. 25, 2014

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Registered investment adviser Structured Portfolio Management, L.L.C. and two affiliated investment advisers have agreed to settle SEC charges stemming from allegedly inadequate compliance policies and procedures that resulted in improper trade allocations among the funds they advised and failure to disclose a change of strategy to fund investors. The respondents, without admitting or denying the SEC's allegations, have consented to the entry of an Order that requires them to retain an independent compliance consultant, censures them, orders them to cease and desist from those compliance violations and imposes a $300,000 civil penalty. For more on SPM, see "Dispute between Structured Portfolio Management and Jeffrey Kong Offers a Rare Glimpse into the Compensation Arrangements between a Top-Performing Hedge Fund Management Company and a Star Portfolio Manager," Hedge Fund Law Report, Vol. 4, No. 8 (Mar. 4, 2011). "Cherry picking" of trades, and the conflicts of interest that arise when advisers allocate trades, have been ongoing focus areas for the SEC. See, e.g., "SEC Charges Hedge Fund Manager and Its Founder with Securities and Investment Adviser Fraud Based on 'Cherry Picking' of Trades," Hedge Fund Law Report, Vol. 6, No. 1 (Jan. 3, 2013).

Background

On August 28, 2014, the SEC entered an Order Instituting Administrative And Cease and Desist Proceedings (Order) against registered investment adviser Structured Portfolio Management, L.L.C. (SPM) and its registered affiliated advisers SPM Jr., L.L.C. (SPM Jr.), and SPM IV, L.L.C. (SPM IV). At relevant times, SPM owned approximately 90% of SPM Jr. and 44% of SPM IV. SPM is the adviser to Structured Servicing Holdings Master Fund, L.P. (SSH). SPM Jr. advised Parmenides Master Fund, L.P. (Parmenides); and SPM IV advised Aqueous Master Fund, L.P. (Aqueous).

SSH and Parmenides invested in mortgage-related securities and had traders dedicated to their core holdings. A different trader (Hedge Trader) was responsible for hedging the funds' interest rate risks by trading liquid securities, including U.S. Treasury securities (Treasuries). In 2006, several years after SSH and Parmenides were launched, SPM launched Aqueous, which invested in a range of liquid U.S. mortgage-related securities and Treasuries. SSH and Parmenides provided seed capital to Aqueous and were among its largest investors. The Hedge Trader was named portfolio manager of Aqueous and continued to hedge trade for the other funds. He traded Treasuries for all three funds.

SPM, SPM Jr. and SPM IV were all subject to SPM's compliance policies and procedures (Compliance Policies), which required trades to be allocated in a "fair and equitable manner in light of the investment objectives and strategies" of the funds. Traders were required to complete a trade blotter that included information on the name, price and amount of the security purchased, the purchasing fund and the name of the counterparty. That information was entered daily into SPM's trade management system. However, the SEC alleges that the blotters were collected only "on a sporadic basis throughout the day without any way of determining when the trader had identified the fund for which the securities were traded in relation to the time that the trade was executed."

Conflict of Interest on Trade Allocations

The Hedge Trader's roles for the three SPM funds created a potential conflict of interest, described by the SEC as follows: "When trading for Aqueous, the Hedge Trader's sole responsibility was to make a profit. In contrast, when trading for SSH and Parmenides, his main responsibility was to hedge interest rate risk." According to the SEC, SPM "recognized and disclosed this potential conflict at Aqueous' inception but did not modify or update its written policies and procedures."

In late 2006, SPM personnel discovered that "when Aqueous, SSH, and Parmenides each purchased the same Treasury security on the same day, Aqueous consistently bought at a lower price than the other two funds. Likewise, when all three funds sold the same Treasury security on the same day, Aqueous consistently sold at a higher price than SSH and Parmenides." As a result, for the next six months, the Hedge Trader was assigned to trade only for Aqueous. He was eventually permitted to resume trading for SSH and Parmenides. However, SPM never amended its Compliance Policies to address the conflict. It simply instructed traders to provide trade blotters more frequently and assigned a junior compliance officer to assure that that occurred. The SEC asserted that SPM should have provided written guidance both as to when blotters had to be submitted and as to the junior compliance officer's duties. See "Trading Practices Session at SEC's Compliance Outreach Program National Seminar Addresses Need for Holistic Compliance Procedures Dealing with Allocations, Best Execution and Cross Trades," Hedge Fund Law Report, Vol. 5, No. 8 (Feb. 23, 2012).

Allocation concerns were raised again both internally and by an outside firm in late 2008. In early 2009, after detecting aberrational performance results, SPM hired outside counsel to review its trade allocations. That review was inconclusive. Aqueous ceased operations in March 2009.

Unlike many cherry picking cases in which an unscrupulous adviser allocates trades to a proprietary account at the expense of its clients, it appears that the principals of SPM did not benefit directly from the allocation failures. Rather, the investors in SHH and Parmenides may have suffered at the expense of investors in Aqueous. See "How Can Hedge Fund Managers Avoid Criminal Securities Fraud Charges When Allocating Trades Among Multiple Funds and Accounts?," Hedge Fund Law Report, Vol. 4, No. 19 (Jun. 8, 2011). It is conceivable that the Hedge Trader did so for his personal benefit because, as Aqueous' head trader, his compensation was likely tied to the performance of that fund; however, there is no indication that the Hedge Trader has been accused of any wrongdoing. SPM was ultimately responsible for the compliance failures that permitted the cherry picking to occur in the first place and to continue after it was discovered. 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 One of Three)," Hedge Fund Law Report, Vol. 6, No. 47 (Dec. 12, 2013).

Disclosure of Aqueous' Investment Objectives

Aqueous' prospectus indicated that it would pursue a highly liquid trading strategy, primarily in mortgage-backed securities, but that it might also invest in "Treasuries and other liquid securities." It followed its stated strategy until mid-2007, at which point it began day-trading mostly Treasuries. In fact, over an 18-month period, "Aqueous had made only two trades that were not trades in Treasuries." Aqueous never disclosed this change of strategy to its investors. In addition to the potential for compliance policy violations, "style drift" at an investment fund can lead to fraud and other serious SEC charges. See "Recent SEC Enforcement Action Provides a Dramatic Example of Style Drift in the Hedge Fund Context," Hedge Fund Law Report, Vol. 4, No. 43 (Dec. 1, 2011). It may also spur investor litigation. See "Investors Sue Hedge Fund Manager Harbinger Capital and Philip A. Falcone for Alleged Style Drift," Hedge Fund Law Report, Vol. 5, No. 22 (May 31, 2012).

Compliance Failures and Specific Violations

The Compliance Policies only required traders to identify on execution the fund for which they were trading. The SEC claims that that was insufficient: Despite being aware of concerns about improper trade allocations, "SPM failed to adopt and implement written policies and procedures reasonably designed to prevent improper trade allocations." Similarly, the Compliance Policies were not "reasonably designed to prevent inaccurate disclosures [about the strategy change]" to investors. As a result, "SPM did not adequately review Aqueous' offering documents and other investor disclosures on a regular basis to determine whether they were inaccurate."

Based on those alleged failures, the SEC claims that the respondents willfully violated Section 206(4) of the Investment Advisers Act of 1940 (Advisers Act), which prohibits fraudulent, deceptive or manipulative conduct by advisers, and Rule 206(4)-7, which requires a registered adviser to "[a]dopt and implement written policies and procedures reasonably designed to prevent violation [by the adviser] of the Act and the rules that the Commission has adopted under the Act. . . ."

Sanctions and Undertakings

SPM has agreed to retain, at its own expense, an independent compliance consultant acceptable to the SEC "to conduct a comprehensive review of [SPM's] supervisory, compliance, and other policies and procedures designed to prevent and detect improper trade allocations and inaccurate investor disclosures." The consultant must be retained within 30 days; within 180 days it must provide a report to SPM and the SEC that contains a description of the review it conducted, its conclusions, and recommendations for revising and improving the Compliance Policies and for implementing those changes. SPM will have an opportunity to contest any recommendations that it believes to be "unnecessary, unduly burdensome, impractical, or inappropriate," but ultimately must abide by the consultant's final recommendations. SPM must cooperate with the consultant, provide written evidence of compliance to the SEC, and maintain records relating to its compliance for six years. The consultant and its affiliates are prohibited from being employed by SPM or its affiliates for two years after the engagement ends.

In addition, SPM has 20 days to send a copy of the Order and an SEC-approved cover letter to all of its advisory clients and its private fund investors. It also must amend its Form ADV to disclose the Order.

SPM must certify to the SEC in writing its compliance with those undertakings.

Finally, the respondents have agreed to the following sanctions:

- SPM, SPM Jr. and SPM IV are censured and ordered to cease and desist from current and future violations of Section 206(4) and Rule 206(4)-7 under the Advisers Act.
- They are ordered, jointly and severally, to pay a civil penalty of $300,000.00.

The respondents neither admit nor deny the SEC's allegations.

For a copy of the Order discussed in this article, click here.

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