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Activist Investing

Top SEC Officials, Law Firm Partners and In-House Counsel Discuss Private Fund Enforcement Priorities, Tender Offer Rules Applicable to Activist Investing, Valuation Challenges, Personal Trade Monitoring and Compliance Testing (Part Four of Four)

Jan. 22, 2015

By Zoe McKelvey, *Hedge Fund Law Report*

This is the final article in a four-part series covering the Practising Law Institute's (PLI) Hedge and Private Fund Enforcement & Regulatory Developments 2014 event, chaired by Barry Goldsmith, a partner at Gibson Dunn & Crutcher and co-head of its Securities Enforcement Practice. The first article in this series discussed points made by Julie M. Riewe, Co-Chief of the SEC's Asset Management Unit, on enforcement trends, principal transactions, conflicts raised by side-by-side management, valuation, allocation of expenses and the potential deterrent value of smaller enforcement actions. The second article addressed CFTC enforcement concerns and cases, New York Attorney General's Office initiatives and defense strategies for avoiding and managing government investigations. The third article focused on best practices for preparing for and responding to SEC inspections and examinations.

This final article in the series summarizes the following additional areas impacting hedge fund managers: (1) current focus areas of the SEC's Complex Financial Instruments Unit, especially as those focus areas relate to instruments traded by hedge funds; (2) the evolving regulatory ecosystem in which activist managers obtain, manage and deploy investment-sensitive information; and (3) the view of top in-house counsel on hedge fund manager compliance policies that are demonstrably effective.

The participants in the relevant PLI panels included Scott Black, General Counsel & Chief Compliance Officer at Hudson Bay; Susanne V. Clark, Senior Managing Director and General Counsel at Centerbridge; Wayne M. Carlin, a partner with Wachtell, Lipton, Rosen & Katz; Marcy Engel, Chief Operating Officer and General Counsel of Eton Park Capital Management, L.P.; Marc J. Fagel, a partner with Gibson, Dunn & Crutcher; Richard W. Grime, a partner at O'Melveny & Myers LLP; Bruce Karpati, Global Chief Compliance Officer and Counsel at KKR; Kahyeong Lee, Associate General Counsel and Compliance Officer at Oak Hill Advisors, L.P.; and Michael Osnato, Chief of the SEC Enforcement Division's Complex Financial Instruments Unit.

Enforcement Focus on Private Funds

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Michael Osnato, Chief of the SEC Enforcement Division's Complex Financial Instruments Unit (CFI) since January 6, 2014, provided an overview of his unit. He explained that CFI was formerly known as the Structured and New Products Unit, and now consists of about 50 people, including investigative attorneys, industry experts and former portfolio managers. CFI focuses on over the counter markets, especially fixed income. In general, he said that his unit is concerned with how complicated financial instruments are created, originated, rated, marketed, sold, traded, valued, and used or misused by the counterparty. He views CFI's role as overlapping with the fund space. The unit's staff aims to understand the products that Wall Street is constantly innovating, including asset backed securities, CLOs, CDS, and pretty much all of the new acronyms describing financial products. "History teaches us that where you have dark, opaque markets with little transparency, there will be fraud," he said.

Osnato provided a brief overview of some of CFI's important investigations in progress. These focus on trading desks, misconduct taking the form of misrepresentations, markups, markdowns, and "basically anything a trader can do with a complicated asset class." CFI is also looking at rating agencies and the potential for ratings fraud in the post-financial crisis environment. The unit is also examining banks and public companies to see how they may be using derivatives to shift or conceal risk. "In the fund space, we have a number of active investigations looking at fraud and breach of fiduciary duty. The cases vary but there tends to be a very simple fact pattern: a manager sitting on top of a portfolio of very hard-to-value instruments." Because valuation drives NAV, performance and other metrics related to fees, it is obviously of concern to managers and may present the temptation to misprice assets. See "K&L Gates Partners Outline Six Compliance Requirements and Four Enforcement Themes for Private Fund Advisers (Part Three of Three)," Hedge Fund Law Report, Vol. 8, No. 1 (Jan. 8, 2015) (under subsection entitled *Valuation*).

Osnato also described the SEC case against Athena Capital Research, LLC, filed on October 16, 2014, explaining that it was "the first real 10b-5 fraud case against a hedge fund engaged in manipulative high-frequency trading." He said that the facts were complicated, involving cutting edge algorithms and sophisticated trading strategies. At the end of each trading day, the NASDAQ runs a closing auction where it tries to satisfy imbalances in either buys or sells, he noted. Hedge fund managers and day traders are familiar with this phenomenon. Athena Capital employed a cutting edge but legal strategy, using collocated servers and low latency, to trade these imbalances while accumulating shares on the opposite side of what it wanted to do on its continuous book. The firm called this part of its strategy "meat."

According to Osnato, "As they got better at this, their strategy turned to locking down the market in the last few seconds of trading, making sure they were the only firm that was trading the most desirable imbalances. So they put together a whole new suite of order types and algorithms to control that aspect of the market, to the point where, at the peak, they were getting filled 98% of the time in the last two seconds of trading."

"If you know you've got the sophistication to get filled almost 100% of the time and you know you're going to be doing most of your trading in the last two seconds," he continued, "then it becomes tempting to develop another kind of algorithm to move the price. They developed a whole suite of new algorithms to place six orders milliseconds apart in the last second or two of the trading day routed throughout the country on exchanges like BATS and NASDAQ. The idea was to overwhelm the market with liquidity and push the price in the direction they wanted it to go, so when they closed out they had a few pennies extra. When they did this across thousands of stocks a day, it added up." They named this strategy "gravy," which proved helpful to the SEC in making its case.

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Osnato stated that the case demonstrates that the SEC has the skills and proficiency to bring a case where the most important scienter evidence was not emails or texts but the computer code. While a regulator might spend months negotiating with a hedge fund manager to get its code, he observed, when the SEC gets it, it can be hard for attorneys to decipher it. The SEC now has the internal quantitative capacity of former coders who lived in this space. These coders worked side-by-side with the SEC's investigative team to help decipher the relevant code and understand and pinpoint where the fraud happened. While the effort was time-consuming, he added, it allowed the agency to merge more classic investigative techniques with the code analysis.

In addition, Osnato noted that the *Athena Capital Research* matter served to "update and refresh" the law on open market trading and what it means to prove fraudulent intent in that space. The cases frequently cited in this area are old – Second Circuit cases from the early 1990s – and the standards are hard, he said. For example, according to Osnato, some of the cases essentially held that there cannot be fraud in open market trading unless fraud was the sole or primary reason for the trade. "The conduct in those cases is also static and old-fashioned and does not include the kind of fluid, algorithmic trading we now see. The *Athena* case is the first step of moving the caselaw forward and matching it with the reality of today's trading."

Osnato also highlighted an SEC opinion, issued on May 16, 2014, against Donald L. Koch and Koch Asset Management, LLC. In what may be equivalent to dicta, he said, the SEC stated in footnote 97 of the opinion that the defendants' "manipulative intent caused them to alter their trading in some material respect." Osnato observed that while this language was not the main focus of the case, it represented a "fairly elastic concept" that may apply to future high-frequency trading cases after *Athena*.

Structural Shift in Fixed Income Market

With respect the classic fund space, Osnato provided insight on how his CFI Unit and the SEC as a whole view the landscape. Within the fixed income market, the CFI was aware of a fundamental realignment: "Dealers, investments banks and trading desks have stepped back from providing liquidity in those markets largely because of the regulatory capital requirements of Basel III. Trader headcount has shrunk and banks no longer hold as many bonds, credit instruments or inventory. Traditionally, the broker-dealers and market makers act as the shock absorber for the markets when they're stressed. They intermediate and provide a level of calmness to tamp down the volatility," he said.

"Over the past few years, the buy side has piled into the fixed income space in risky areas like junk bonds and leveraged loans, and you have a massive explosion of holdings in that space," Osnato continued. "Right now the market is relatively calm, absent some blips in the treasury market. When things change, however, the dealers will not be there in the same way to moderate that market. If the buy side shows its expected bias to get out, and there's nobody there to take the other side, there could be problems for the markets."

As a result, he explained that the SEC was concerned that volatility, an inability to timely execute trades, and downward price pressure presented perfect ingredients for misconduct. As products get more complicated, he added, risk goes up. He said that valuation presented a risk in the fund space for the sizeable class of managers with concentrated holdings of fixed income and particularly exotic fixed income. "When the market moves and those managers can't trade out, they may mark their bonds inappropriately. When they do go to the dealer community, you will see more cases involving intermediation of trades." In addition, he noted that redemption

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presented a risk for fraud if a manager cannot generate enough liquidity to satisfy redemption requests.

In response to a question from Goldsmith on how the SEC is attempting to identify potential misconduct, Osnato replied that the agency is proactively looking at market patterns and market players who fit certain profiles. He said that the *Athena* case came to the SEC through market surveillance conducted by SROs, which have become increasingly sophisticated in their ability to screen for aberrational HFT trading. He added that the large stock exchanges are helpful in identifying layering, spoofing and HFT patterns.

Questions Surrounding Activist Trading

Allergan Case

Carlin said that the *Allergan* case broke into public domain in April 2014. See "Did Pershing Square and Valeant Violate Insider Trading, Antitrust or Tender Offer Rules in Their Pursuit of Allergan?" Hedge Fund Law Report, Vol. 7, No. 17 (May 2, 2014). At first, the approach was hailed as a potential brilliant new takeover tactic, representing the first time a hedge fund manager had teamed up with a strategic bidder in an attempt to take over another company. "The hedge fund manager was Bill Ackman of Pershing Square, the well known activist investor. The strategic bidder was Valeant, a pharmaceutical company. The target company that Pershing Square and Valeant teamed up to pursue was Allergan, also a pharmaceutical company. When this tactic was made known, many wondered if it was the beginning of a new wave of similar efforts by other hedge fund managers to partner up with strategic acquirers to take over companies," Carlin explained.

Initially, it appeared that the tactic could bring significant advantages for the strategic acquirer, given that Pershing Square, through a fund that it managed, was able to accumulate 9.7% of the stock or options of Allergan before anything was made public. People soon began to question the legality of the tactic. "We now know that the answer may very well be that there is a serious question based on the Nov. 4, 2014 decision by the California district court on the motion for the preliminary injunction," Carlin said.

Carlin provided the basic factual background of the case. "Valeant and Pershing entered into a confidentiality agreement and then Valeant disclosed to Pershing that the company that Valeant was trying to acquire was Allergan. Both parties did additional work, and then a few weeks later, they entered into a relationship agreement that set out how they were going to work together to try to acquire Allergan. Under this relationship agreement, they agreed that a co-bidder entity was to be formed. It was a fund to be managed by Pershing and called PS Fund 1 and that was to be the vehicle for acquiring Allergan stock in the open market," he said.

"At the same time that they entered into this agreement and formed what they called a co-bidder, Pershing Square as the manager of that fund went out into the market and started buying Allergan stock. By April 2014, PS Fund 1 had gotten to the 9.7% level and filed a Schedule 13D. Through rapid acquisition from the point that they stepped over the 5% line until 10 days later when they had to file the Schedule 13D, they got all the way up to 9.7%," Carlin explained.

"After Pershing Square filed that 13D, Valeant issued a press release announcing that it had communicated an unsolicited bid for Allergan to Allergan's board and CEO. Allergan's stock shot up by 22% and as that happened, Pershing Square, through the holdings of PS Fund 1, had an

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instant paper gain of over $1 billion. After some additional back and forth, by June 2014, Valeant announced a hostile tender offer for Allergan's shares," he said.

"The major question that arises from those events is, did this market activity involve unlawful insider trading under the circumstances. Most insider trading theories grounded in SEC Rule 10b-5 would not apply here because they all require some kind of breach of duty by somebody in the chain of transmitting information, which is not present in this fact pattern. PS Fund 1 and Pershing Square did not have any of Allergan's nonpublic information. They did have Valeant's nonpublic information – its plans to seek to acquire Allergan and plans for a tender offer – but Valeant wanted Pershing Square to go ahead and trade while in possession of that information. There was not a breach of duty in that connection. So the 10b-5 theories do not work in this setting."

Carlin continued, "What that leaves is SEC Rule 14e-3, which prohibits trading while in possession of information about a tender offer. Rule 14e-3 does not have the breach of duty requirement that is part of insider trading law under Rule 10b-5. Rule 14e-3 says that if a person has taken a 'substantial step' to commence a tender offer, then it is a violation for any other person to trade while in possession of material nonpublic information about that prospective tender offer if that information comes from the offeror. There are therefore two legal issues raised here: (1) were there substantial steps taken prior to the trading? and (2) how do you characterize the entity that did the trading?"

"Regarding the question of substantial steps, in the litigation that followed, Pershing and Valeant argued that up until and through the time of the stock purchases, they had taken steps only toward a negotiated acquisition. Their argument was that no steps toward a tender offer were taken until later on. The issue of what constitutes a substantial step is a case-by-case question and turns on the facts and particular circumstances." There is no standard checklist one can consult to determine whether substantial steps have been taken to commence a tender offer, he said.

Carlin noted that the court in this case pointed to a number of aspects of the events as bearing on the question of whether there were substantial steps taken to commence a tender offer. These included the following facts: (1) Valeant held multiple board meetings to discuss the transaction; (2) there were internal emails and slide presentations circulated both inside Valeant and inside Pershing Square, which alluded to the likelihood that this would end up having to be a hostile acquisition because it was expected that Allergan would oppose it; (3) Valeant hired three different law firms and reached out to hire investment bankers; (4) the relationship agreement that governed how Pershing Square and Valeant were working together basically set out the plan for Pershing Square to acquire the securities through the fund it was managing; and (5) the relationship agreement referred to the formation of the co-bidder entity, providing that in the event of a tender offer, Pershing Square and its fund would be identified as a co-bidder in a tender offer if one happened.

Valeant and Pershing Square pointed to a provision that they had written into their agreement, which said that "the parties acknowledge that no steps have been taken towards a tender or exchange offer for securities of Allergan," Carlin explained. Nonetheless, he noted that the district court found that "just because you write that in your agreement, does not make it so." According to Carlin, the court found that that contractual language did not override the facts indicating substantial steps towards commencing a tender offer, such as those described above. He added that the court had concluded that the plaintiffs had raised at least serious questions about whether the "substantial step" element was satisfied.

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Carlin also explained a second legal issue under Rule 14e-3 regarding whether Pershing Square's managed fund, PS Fund 1, was an "other person," other than the offering person, for purposes of Rule 14e-3. Valeant and Pershing Square argued in the litigation that since they were identifying Pershing Square as a co-bidder, that meant that Pershing Square, with that label on it, could trade without violating Rule 14e-3 and that being a co-bidder meant that Pershing Square was not an "other person" for purposes of the rule. According to Carlin, this represented "an attempt to introduce into Rule 14e-3 a concept that is not really in Rule 14e-3 – that there can be somebody who is not an offering person in a tender offer, but who can still trade without violating Rule 14e-3." The concept of a "co-bidder" does exist in the context of tender offer disclosure requirements, he explained, "where the regulatory purpose is to make sure that shareholders have information about a party whose involvement in a tender offer is sufficiently significant that you want shareholders to have information about that party and its activities."

"The regulatory purpose of Rule 14e-3, which does not have the term or the concept of 'co-bidder' in it, is very different. The regulatory purpose is to prevent someone who is not the person making the tender offer from making unfair use, and profiting unfairly and profiting at the expense of unknowing shareholders by trading while knowing of the impending tender offer. Given that purpose of Rule 14e-3, the category of people who can trade under Rule 14e-3 is a very narrow one. On the preliminary injunction motion, the court found persuasive the argument that the plaintiffs made that to be an offering person for Rule 14e-3 purposes, you should be someone who is trying to buy stock in a tender offer. The only party that was trying to buy stock in a tender offer here was Valeant. Though in the preliminary injunction context, this is the full extent of the law that we have addressing this scenario and it makes clear that following this kind of approach presents significant risks of running into a conclusion that you have violated Rule 14e-3," Carlin said.

Goldsmith noted that recent developments – the announcement that another company would acquire Allergan and that Valeant would not try to top that bid – possibly mooted this case. Carlin agreed that it was unclear whether the issues raised would be resolved in pending litigation. Grime added that the district court's opinion had also raised an additional potential proxy claim that plaintiffs might have under Section 14(a) of the Securities Exchange Act of 1934 based on a failure to disclose potential liability under Rule 14e-3.

Information Leakage

Fagel discussed the uncertainty of insider trading law as applied to activist funds that trade while in possession of material nonpublic information based on their own activist position that may move the price of a security. For instance, when Pershing Square planned to take a public short position in Herbalife stock, it is unclear whether trading by Pershing Square in advance of that announcement would constitute insider trading. The SEC "found a way around" that issue, according to Fagel, by suing the friend of the roommate of someone who worked with Bill Ackman. As Fagel explained it, "The roommate heard that Pershing Square was going to take the short position in Herbalife and tank the stock." The roommate told his friend, who made about $47,000 shorting in advance of Pershing Square's position, and even tried to cancel his trade at some point before it went through. Fagel surmised that the SEC may have discovered this relatively small insider trading maneuver in connection with a broader look at trades surrounding Pershing Square's activist trading. The SEC has since voluntarily dismissed the insider trading case arising out of Pershing's statements on Herbalife. He counseled fund managers to therefore be cautious about information leakage and potential tipping around managers' own reports. Maintaining the confidentiality of your own information is critical, he stressed.

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Fagel noted that the SEC has recently brought cases against managers alleging a lack of sufficient internal controls sufficient to prevent their own employees from trading on MNPI. "Idea dinners" also present dangers, he said, especially considering the SEC's willingness to prosecute managers based only on their lack of adequate compliance policies, even absent any insider trading. See "'Best Ideas' Conference Presentations: Challenges Faced by Hedge Fund Managers Under Federal Securities Law (Part Two of Two)," Hedge Fund Law Report, Vol. 7, No. 31 (Aug. 21, 2014).

Establishing an Effective Private Fund Compliance Program

The panelists agreed that a fund manager's compliance team must thoroughly understand and "embed itself" into the business and day-to-day operations of the managing firm. For instance, analysts from different firms often compare information, and a compliance program should not automatically treat a beneficial business practice as a breach of policy. A contextualized and good faith determination that a certain activity benefits clients may be necessary. The panelists also agreed that certain protocols were critical.

For instance, Lee favors setting up a list of approved vendors for expert consultations by research analysts. This also allows proper billing and making sure that only valid research is allocated as an expense to one of the manager's funds when warranted. Engel suggested using a due diligence questionnaire in connection with consultations with every source other than an official publication. Clark added that she makes sure that the leadership of any firm that her firm is dealing with understands how careful her firm wants to be. Clark regularly speaks with and visits the compliance team at any consulting firm that provides information to her firm. Occasionally, her compliance department clarifies to consultants that her firm does not want to see particular types of information. See "Best Practices for Due Diligence by Hedge Fund Managers on Research Providers," Hedge Fund Law Report, Vol. 6, No. 11 (Mar. 14, 2013).

The panelists agreed that using a reporting form internally for any consultation with an expert network makes sense. See "K&L Gates Partners Identify Eight Actions That Hedge Fund Managers Can Take to Avoid Insider Trading Violations (Part Two of Three)," Hedge Fund Law Report, Vol. 7, No. 44 (Nov. 20, 2014) (subsection under *Expert Networks*). The form serves the dual purpose of requiring the employee and expert to affirm that they have complied with an appropriate script, disclosure and procedure, while also providing a log or internal record of all contacts that the manager has had with expert networks. The log may be compared quarterly with that of the expert network to ensure that people internally are reporting every contact.

Testing

Black explained that to test that a fund manager's internal procedures are working, it makes sense to conduct both internal and external surveillance. Internal review may include: (1) reviewing restricted lists and comparing them to recent trades done, positions owned, and all investments in the portfolio; (2) analyzing your investors and potential conflicts of interest; and (3) reviewing vendors and the general ledger used to make payments to them, checking whether every consultant has filled out the required form and comparing that to the payments to the vendor that have been documented in the ledger. External testing would likely involve: (1) checking how your firm's trading volume compares to the industry volume; (2) testing your firm's trading in relation to corporate action activity, noting stock events related to proxy season,

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dividends or mandatory redemptions; (3) reviewing personal trading following important news involving a particular company; and (4) analyzing the fairness of NAV on a longer term basis to test allocations and valuations based on market data and available pricing information. See "Key Legal and Operational Considerations for Hedge Fund Managers in Establishing, Maintaining and Enforcing Effective Personal Trading Policies and Procedures (Part Three of Three)," Hedge Fund Law Report, Vol. 5, No. 6 (Feb. 9, 2012).

Black added that sample testing and case-by-case testing of the effectiveness of procedures in place are both necessary. He provided an example of case-by-case testing of his firm's policy that employees must pre-clear all of their traded securities, but that they are free to trade ETFs (which do not raise the same insider trading concerns as individual securities) unless a single position accounts for more than 10% of the ETF. Black said that his assistant must review all ETF transactions each quarter to make sure that policy was actually followed. For a policy on the calculation of management fees, or a similar issue that the compliance department is not dealing with on an everyday basis, "we might take one or two months in particular, look at them over the course of the year and just make sure accounting is going through the procedures. So that's something we would sample on."

Conflicts of Interest

Clark said that testing of the firm's policies regarding conflicts of interest will vary depending on the potential conflict. Compliance can examine whether opportunities presented to the fund's investors are also benefiting any employees personally and ensure that portfolio decisions are being made for the right reasons. Compliance can also monitor that gifts and entertainment are being purchased and delivered in a manner consistent with best execution for the funds. Black added that simple email key word monitoring can surprisingly reveal many potential conflicts of interest.

Engel observed that operations can help compliance set up a system to identify any transactions done outside a set parameter of trade allocations by highlighting any exceptions to a policy. In the old days, she added, you would have had to look at every trade, which would have been onerous. Similarly, she said, compliance can use technology to monitor fund expenses, which are also an area of concern to the SEC. "If you're setting up your processes for your RFPs and making very clear at the beginning that the request for payment has to identify what the expense is for and what entity it goes to, and then someone has to pre-approve an expense before it can be allocated as a fund versus a management company expense, you will catch a problem at the beginning. If you also have a process after the fact for identifying things outside of pre-approved contracts, you can catch a lot of incorrectly booked expenses."

Black added that another pre-disclosure requirement his firm uses is to ask all employees to identify any relationships they have with the firm's outside vendors. This allows compliance to determine whether there is a potential conflict that needs to be monitored.

According to Lee, compliance should also take the time to monitor potential conflicts affecting clients' accounts with similar, but not identical, strategies in order to avoid inter-account conflicts of interest. For example, when clients all want to invest in the same asset, the question arises of how to allocate limited resources. The same issue is relevant to allocations between clients investing in different classes in the same issuer. She said that different portfolio managers running different accounts within the firm might even take divergent views on the same asset – as to when the portfolio manager has hit his investment target and wants to dispose of a position. The review of such potential conflicts often involves messy facts and requires a principled, nuanced analysis, she said.

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Optimizing an Already Great Compliance Program

Goldsmith asked the panelists how they would suggest taking an already great compliance system to the next level. Lee suggested using technology to further your program. Improving an "already mature situation" with manuals already existing is often an art, rather than a science. She suggested that the compliance leader (1) identify the risk and why your proposal is a solution to that risk; (2) come up with a solid recommendation; and (3) carefully effect the desired behavior change. "For example, if the issue is that you want to make some of the post-trade testing that you've done a preventative test – a flag that prevents a trade from occurring – then you might want to import some market data and restrictions into the order management system, which you're using as an actual order flow system. So that's the solution you would propose, and then you would have to go about comparing vendors, data sources, and doing your regular diligence, including diligence on information security."

When proposing change, Lee said, the compliance personnel should be mindful of the current firm environment and how to use events, such as recent enforcement activity in the industry, as a basis for a conversation and a "catalyst." Likewise, compliance professionals should show respect and validation for the process already in place, and try to figure out why people at the firm perceived the "old way" of addressing various issues as sufficient. "There could be things you could learn from that discussion," she emphasized. Finally, Lee said that there was no substitute for one-on-one conversations with people, or talking directly with operations and trading personnel. Realizing that the "project" of implementing improvement to a compliance system takes time, she urged compliance officers and counsel not to be shy about taking up space and time on peoples' calendars in order to complete the project thoughtfully.

Engel added that counsel should not expect the technology department to be able to quickly "automate" without thoroughly understanding the objective and required process. According to Clark, use case testing may be valuable in allowing developers to understand the goals of a compliance project in specific terms so that they can code correctly to create the tool or the tester needed. "We work hard to give the developers use case scenarios – three or four for instance. If you show you've been thoughtful about why something should be added, that's half the battle," she added.

Clark explained the "acid test," which she has found useful for evaluating whether a firm's policy on a difficult area like valuation is being properly implemented. This test requires examining the market at which the manager carried a hard-to-value position and the market at which it exited the position, and then explaining any delta. For prices that have not moved in a long time, the manager can report how long the price has remained static and then compare that information to what has gone on in the market to validate that the professionals have not been ignoring relevant events or carrying an asset at a price that is valued too highly, she said. The compliance team may also look at the depth of various price quotations, if a published pricing source is used to determine price instead of broker quotes. She noted that such published pricing sources are not always correct or deep in the number of quotes that they gather. Finally, she advised that the compliance team should consider who is obtaining price quotes, whether that provider is appropriately disinterested, and whether impermissible motivations might have skewed the quotes. See "Three Pillars of an Effective Hedge Fund Valuation Process," Hedge Fund Law Report, Vol. 7, No. 24 (Jun. 19, 2014).

Cybersecurity

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Engel likened the cybersecurity threats to fund managers to continually mutating viruses. The compliance personnel must obviously identify the manager's systems and vulnerabilities, including those posed by vendors, prime broker relationships, cashwire systems with banks, the CRM system and the administrator. See "Critical Components of a Hedge Fund Manager Cybersecurity Program: Resources, Preparation, Coordination, Response and Mitigation," Hedge Fund Law Report, Vol. 8, No. 2 (Jan. 15, 2015). Unlike banks, most hedge funds do not have a tremendous amount of high risk data, she said, yet significant risks to security might still stem from bad actors internally or hackers externally. Simple protections like password requirements, limits on log-in attempts, malware detectors, and sensitive document downloading or printing alerts may all go a long way towards increasing the security of the firm's data. A manager should also develop a proactive disaster recovery plan. See "SEC Risk Alert Describes Deficiencies Found During Reviews of Investment Advisers' Business Continuity and Disaster Recovery Plans and Recommends Best Practices for Such Plans," Hedge Fund Law Report, Vol. 6, No. 37 (Sep. 26, 2013).

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