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Chief Compliance Officers

SEC Enforcement Action Shows Hedge Fund Managers May Be Liable for Failing to Adequately Support Their CCOs

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A recent SEC enforcement action asserts the imperative of having an effective and empowered chief compliance officer (CCO) as well as effective compliance policies and procedures – and actually following those procedures. Even inadvertent flaws can have serious consequences. The SEC alleged that investment adviser Pekin Singer Strauss Asset Management Inc. (Pekin Singer) and three of its principals failed to provide sufficient support and resources to its CCO, which led to the firm's failure to conduct timely annual compliance reviews for the years 2009 and 2010 (among other compliance failures). The SEC also claimed that Pekin Singer neglected to seek best execution for clients when it created a new, lower-fee share class for a mutual fund that it advised but failed to move certain eligible clients into that less expensive share class.

Without admitting or denying the SEC's charges, Pekin Singer and other respondents agreed to a settlement order pursuant to which they must pay $285,000 in civil penalties and are subject to other sanctions and undertakings. This article summarizes the facts giving rise to the enforcement action; the SEC's specific charges; and the settlement terms. This settlement comes at a time when there is a sense in the industry that CCOs are increasingly in the SEC's cross-hairs; however, the Pekin Singer CCO was not named in the enforcement action. See "SEC Commissioner Issues Statement Supporting Hedge Fund Manager Chief Compliance Officers," Hedge Fund Law Report, Vol. 8, No. 28 (Jul. 16, 2015); and "SEC Commissioner Speaks Out Against Trend Toward Strict Liability for Compliance Personnel," Hedge Fund Law Report, Vol. 8, No. 25 (Jun. 25, 2015).

For a general discussion of CCO duties and potential liabilities, see "Five Steps That CCOs Can Take to Avoid Supervisory Liability, and Other Hedge Fund Manager CCO Best Practices," Hedge Fund Law Report, Vol. 8, No. 12 (Mar. 27, 2015); and "Dechert Partners and Venor Capital General Counsel Describe the Scope of Supervisory Liability for Hedge Fund Manager Personnel," Hedge Fund Law Report, Vol. 7, No. 26 (Jul. 11, 2014).

Background

Pekin Singer has been a registered investment adviser since 1989 and currently has nearly $1.1 billion in assets under management. In 2006, Pekin Singer launched, and serves as investment adviser to, the Appleseed Fund (Appleseed), an open-end mutual fund that presently has about $280 million in net assets.

Ronald Lee Strauss (R. Strauss) served as President of Pekin Singer until his resignation in June 2014; he now serves as a senior adviser and member of Pekin Singer's board of directors. At all relevant times, he managed the firm's operations and supervised its employees. William Andrew Pekin (Pekin) is a portfolio manager for Pekin Singer, who became its chairman in July 2014. Joshua Daniel Strauss (J. Strauss) is a portfolio manager for Pekin Singer, who became a co-CEO of the firm in July 2014.

Multi-Hatted Chief Compliance Officer

From 2005 through 2007, Pekin Singer had a chief compliance officer (CCO) who also served as its chief financial officer (CFO). In 2006, Pekin Singer hired an unnamed individual (Officer) to perform a number of roles for Pekin Singer as an analyst, portfolio manager and in other capacities. In June 2007, the Officer was promoted to serve as the firm's CCO, even though Pekin Singer knew he had "limited prior experience and training in compliance." After the promotion, the Officer also retained his other responsibilities. Pekin Singer relied on the Officer's predecessor CCO, who was retiring, to assist and train him; the Officer also attended a compliance conference in 2008.

The Officer made certain incremental improvements to Pekin Singer's compliance program, implementing a personal trading policy and trade allocation and execution testing. Despite his efforts, the SEC claimed that the "Officer lacked experience, resources, and knowledge as to how to adopt and implement an effective compliance program or how to conduct a comprehensive and effective annual compliance program review." For compliance functions and review benchmarking, see "ACA 2014 Compliance Survey Covers SEC Exams, CCOs, Compliance Reviews, Custody, Fees and Personal Trading," Hedge Fund Law Report, Vol. 7, No. 46 (Dec. 11, 2014). See also "ACA Compliance Report Facilitates Benchmarking of Private Fund Manager Compliance Practices (Part One of Two)," Hedge Fund Law Report, Vol. 6, No. 38 (Oct. 3, 2013); and Part Two of Two, Vol. 6, No. 39 (Oct. 11, 2013).

Pekin Singer's 2008 compliance review was limited to trade allocation and execution testing. Pekin Singer did not complete another annual review or testing of its compliance program or code of ethics until late 2011. The SEC charged that R. Strauss was instrumental in that failure; R. Strauss instructed the Officer to give his non-CCO duties priority over his CCO duties. In addition, in 2009, R. Strauss added the role of CFO to the Officer's duties. Consequently, according to the SEC, the Officer devoted a mere 10% to 20% of his time to compliance.

R. Strauss also rebuffed the Officer's repeated requests for assistance. In January 2011, Pekin Singer finally retained a compliance consultant (Consultant) to assist the Officer – and only at the urging of Unified Series Trust, the open-end investment company that provides back office support, accounting and other services to Appleseed and other independently advised mutual funds. Even then, R. Strauss reduced the scope of the Consultant's engagement to trade testing for a six-month period in 2010. See "The Role of Outsourced Compliance Consultants in the Hedge Fund Compliance Ecosystem," Hedge Fund Law Report, Vol. 7, No. 25 (Jun. 27, 2014).

Compliance Failures

The Consultant's report, issued in June 2011, cited a number of compliance deficiencies at Pekin Singer. Prior to the issuance of that report, SEC exam staff had also conducted an examination of Pekin Singer and cited several compliance deficiencies, including the failure to conduct annual

reviews for 2009 or 2010 and a violation of Pekin Singer's code of ethics involving certain personal trading. Pekin Singer finally completed its compliance reviews for 2009 and 2010 in mid-December 2011, "partially in response to a firm deadline" imposed by Unified Series Trust. See "Four Essential Elements of a Workable and Effective Hedge Fund Compliance Program," Hedge Fund Law Report, Vol. 7, No. 32 (Aug. 28, 2014).

The reviews by the Consultant and the SEC also revealed a number of other violations of Pekin Singer's code of ethics and compliance policies, including employees' failures to pre-clear certain trades; failure to obtain employee compliance certifications, documentation on best execution, employee trading and employee holdings; and failure to conduct regular reviews of its code of ethics or an annual compliance meeting. According to the SEC, Pekin Singer's Form ADV filings indicated that Pekin Singer imposed certain restrictions on employee trading and obtained annual compliance certifications and securities holdings reports from employees. However, Pekin Singer's Forms ADV failed to disclose that certain of those provisions were not being followed or enforced.

Failure to Seek Best Execution

According to the SEC, when Pekin Singer formed Appleseed, the fund had a single share class (APPLX). As of February 2009, APPLX shares had an expense ratio of 1.24%. In January 2011, Pekin Singer, Pekin and J. Strauss created a new "investor" class for Appleseed (APPIX) that had an expense ratio of .99%. The .25% difference in expense ratios was paid to Pekin Singer as an administrative fee to compensate it, in part, for the higher platform fees that it paid for APPLX shares.

APPIX shares required a minimum investment of $100,000. Investment advisers could aggregate their clients' Appleseed holdings in order to qualify to buy APPIX shares. Consequently, Pekin Singer's separately managed account clients, who had about $29 million in the aggregate invested in Appleseed, were all eligible to own APPIX shares.

Most of Pekin Singer clients traded through "Broker-Dealer A," which charged a $16 annual fee per account and $12.50 per trade for both APPLX and APPIX shares. The cost to Pekin Singer of investing clients in APPLX and APPIX shares was the same. Thus, "by keeping its clients in APPLX, Pekin Singer could collect the [.25%] administrative services fee without incurring any additional platform costs."

The respondents apparently reasoned that they were not obligated to move their clients into APPIX shares, viewing the .25% difference between the two share classes (and the corresponding administrative fee) as a "negotiable investment advisory fee." The SEC claimed that, by failing to move its clients into APPIX shares, Pekin Singer failed to seek best execution for those clients. The failure to do so cost Pekin Singer clients an additional $307,242 in fees paid to Appleseed.

In contrast, a number of Pekin Singer clients traded through "Broker-Dealer B," which charged Pekin Singer 40 basis points for APPLX shares and 10 basis points for APPIX shares. Pekin Singer moved most of such clients into APPIX shares because, even though it lost the .25% administrative fee, it saved 30 basis points, for a net gain to Pekin Singer of 5 basis points.

The SEC alleged that Pekin Singer failed to disclose to its clients the conflict of interest it had in selecting an Appleseed share class for the clients. It also failed to disclose its failure to seek best execution for Appleseed shares. As with the compliance program failures, such failures led to material misstatements or omissions in Pekin Singer's Forms ADV, which indicated that Pekin Singer would seek best execution for its clients. See "Katten Forum Identifies Best Practices for

Hedge Fund Managers Regarding Best Execution, Soft Dollars, Principal Trades, Agency Cross Trades, Cross Trades and Trade Errors," Hedge Fund Law Report, Vol. 7, No. 10 (Mar. 13, 2014).

For coverage of other SEC enforcement actions arising out of failure to seek best execution, see "SEC Sanctions Dual-Registered Investment Adviser/Broker Dealer for Disclosure Failures and Breaches of Rules Regarding Best Execution, Compliance Policies and Principal Transactions," Hedge Fund Law Report, Vol. 7, No. 33 (Sep. 4, 2014); "SEC Sanctions Two Dually-Registered Investment Advisers for Failing to Obtain Best Execution for Clients," Hedge Fund Law Report, Vol. 6, No. 34 (Aug. 29, 2013); and "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).

Pekin Singer Remedial Efforts

The SEC noted that Pekin Singer promptly undertook a number of remedial measures. These included paring back the Officer's non-compliance-related duties; retaining counsel to advise on regulatory matters; hiring a full-time compliance director to support the CCO; expanding its use of the Consultant; retaining the Consultant to advise at least through the end of this year; and hiring a dedicated CCO to take over for the Officer, who remains with Pekin Singer as CFO.

The SEC also credited Pekin Singer with discovering the Appleseed share class issue during the SEC's review; voluntarily disclosing the issue to the SEC; conducting an investigation of the issue through outside counsel; and voluntarily reimbursing affected clients for the entire $307,242 of excess fund expenses they paid, together with an estimate of the investment returns they lost by virtue of paying the higher fees (an additional $53,439). The SEC took all of those factors into account in agreeing to the settlement.

Specific Violations and Sanctions

The SEC claimed that, by reason of the conduct summarized above, the respondents violated the following provisions of the Investment Advisers Act of 1940 (Advisers Act) and its rules:

- *Code of Ethics.* Pekin Singer willfully violated Section 204A and Rule 204A-1, which requires investment advisers to "establish, maintain and enforce a written code of ethics. . . ." R. Strauss caused that violation.
- *Compliance Policies and Reviews.* Pekin Singer willfully violated Section 206(4) 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 Advisers Act and its rules and to conduct an annual review of the adequacy of those policies and procedures. R. Strauss caused that violation.
- *Misstatements in Forms ADV.* Pekin Singer and R. Strauss, who signed Pekin Singer's Forms ADV, willfully violated Section 207, which makes it unlawful to make any material misstatement or omission in any filing with the SEC. Pekin and J. Strauss caused that violation.
- *Fraudulent Conduct.* By reason of its failure to move clients into the APPIX share class, Pekin Singer willfully violated Section 206(2), which prohibits a registered adviser from

engaging in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." Pekin and J. Strauss caused that violation.

The SEC observed that under applicable precedent, to prove a "willful" violation, the SEC need only show that "the person charged with the duty knows what he is doing." There is no requirement to prove that the respondent knew that he or she was violating a specific rule. (Citations omitted.)

Without admitting or denying the SEC's allegations, the respondents have consented to the following sanctions:

- Each respondent is ordered to cease and desist from future violations of the Advisers Act sections and rules that each is alleged to have violated.
- Each of R. Strauss, J. Strauss and Pekin is censured.
- Pekin Singer must pay a civil monetary penalty of $150,000. Each of the individual respondents must pay a civil monetary penalty of $45,000.
- R. Strauss is suspended for one year from association in a compliance or supervisory capacity with any investment advisers, broker-dealers, investment companies and certain other securities businesses. He must certify compliance with these sanctions within 60 days after the end of the suspension.

Implications of the Settlement

The settlement carries several implications for the hedge fund industry.

First, this case serves to emphasize the paramount importance of a manager's CCO and the need for the manager to fully support and empower the CCO. At the heart of this action is the fact that Pekin Singer failed to ensure it had a suitable CCO in place and, when that CCO sought assistance, the principals of Pekin Singer denied the CCO that aid. Hedge fund managers should take note and ensure that their compliance staff is appropriately supported and able to fulfill their function.

In addition, the SEC enforcement action against Pekin Singer serves as a counterpoint to the growing sentiment within the compliance community that CCOs are being besieged by the SEC and subjected to harsh enforcement actions. SEC Commissioner Daniel M. Gallagher recently issued a statement regarding the trend toward strict liability for compliance personnel, while SEC Commissioner Luis A. Aguilar issued a subsequent statement supporting CCOs. In fact, in his remarks, Aguilar specifically cited the Pekin Singer settlement as an example of the SEC's focus on investment advisers and management personnel, rather than simply pursuit of the CCO. As Aguilar noted, the CCO in this case was not even charged by the SEC.

Another potential lesson to be learned from this case is the need to ensure that CCOs who also serve other functions are able to devote sufficient business time to carry out their compliance duties. The Pekin Singer CCO arrangement was unique in that the Officer wore several hats; a more common arrangement is for a firm CCO to wear two hats at most (such as a general counsel that also serves as CCO). However, even in a situation where a CCO is only wearing two hats, it is important that the non-compliance duties do not overshadow the officer's compliance responsibilities. For more on dual-hatted GC/CCOs, 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); and "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).

Finally, the Pekin Singer settlement illustrates the importance of being proactive and cooperating with the SEC when violations are noted. In this case, Pekin Singer undertook remedial efforts and cooperated with the SEC (including self-reporting the issue with the Appleseed share classes upon discovery). The SEC took those remedial measures into account, undoubtedly mitigating the Pekin Singer settlement terms. Compared to other recent SEC enforcement actions, the penalties in this case are quite low.

To read the order against Pekin Singer, R. Strauss, Pekin and J. Strauss, click here.