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Risk Management

SEC Chair Highlights Two Types of Risks Hedge Fund Managers Must Consider

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By William V. de Cordova, *Hedge Fund Law Report*

The SEC regards required registration and reporting under the Dodd-Frank Act as critical for increasing transparency and protecting investors in hedge funds and other private funds. However, as SEC Chair Mary Jo White recently noted at the Managed Funds Association Outlook 2015 Conference held in New York, the SEC is entering "a new phase of oversight." In her remarks, White discussed what the SEC has learned – and will continue to focus on – regarding the risk profiles of private funds. White also enumerated risks and challenges for private funds and their advisers that can have a systemic impact, as well as firm-specific risks that hedge fund managers and other advisers should actively consider in their businesses. This article summarizes White's remarks.

For additional insight from White, see "SEC Chair White Describes the SEC's Game Plan with Respect to the Asset Management Industry," Hedge Fund Law Report, Vol. 7, No. 47 (Dec. 18, 2014); "Seven Cybersecurity Risks That SEC Examiners Will Look For in Examinations of Hedge Fund Managers," Hedge Fund Law Report, Vol. 7, No. 17 (May 2, 2014); and "Top SEC Officials Discuss Hedge Fund Compliance, Examination and Enforcement Priorities at 2014 Compliance Outreach Program National Seminar (Part One of Three)," Hedge Fund Law Report, Vol. 7, No. 7 (Feb. 21, 2014).

Introduction

White noted that July 2015 marked the fifth anniversary of the Dodd-Frank Act, which required the SEC to implement "a significant number of regulatory mandates, most of which are now completed." Characterizing the rules creating new registration and reporting requirements for private fund advisers as "most prominent" for the audience, she explained that approximately 1,500 new private fund advisers have registered with the SEC, allowing the Commission to gather "considerable data on these advisers and their funds."

"The regulatory regime for private fund advisers addresses two broad areas of risks: firm-specific risks and risks that may also affect the broader asset management industry and potentially the financial system," said White, explaining that the two sets of risks are frequently intertwined, without clear delineation between "firm" and "system."

The SEC has garnered information from the nearly 30,000 private funds managed by 4,500 registered advisers about potential risks for individual firms as well as the broader financial system, White stated. This information has given the SEC insight into the size, geographic distribution and investment concentrations in the industry, in addition to data reflecting private

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fund strategies, including the use of leverage and counterparty exposures. "Excessive leverage, lack of liquidity, and asset concentrations have in the past been at the root of financial crises," she noted, "and we now have the regulatory tools to help better identify and appropriately mitigate potential problems."

White also said that registration and reporting have enabled staff in the Office of Compliance Inspections and Examinations (OCIE) to conduct targeted presence exams, and, when appropriate, the Division of Enforcement to bring actions for serious violations. She cited conflicts of interest and inadequately disclosed fees and expenses as examples of the serious firm-specific risks that have been identified through this process.

Understanding the Industry through Registration and Reporting

"Before 2010, the Commission had relatively limited insight into private funds and the business of private fund advisers," White said, noting that the SEC had lacked even basic knowledge of the number of advisers that existed. However, the Dodd-Frank Act provided the SEC and the public with "census information" about private fund advisers and their funds, as well as "important information about affiliated entities and service providers that perform critical roles as 'gatekeepers.'"

Form PF "provides rich data about private funds to the Commission and other regulators, including the Financial Stability Oversight Council (FSOC)," argued White, pointing out that data from three full sets of annual Form PF data, plus eleven sets of quarterly Form PF filings, enable the SEC to assess potential risks to the U.S. financial system and monitor trends in the industry.

For example, while the number of private fund advisers has not changed appreciably since 2013, the number of large hedge fund advisers with at least $1.5 billion in hedge fund assets has increased by approximately 15%, she noted. Likewise, the number of private funds reported from 2013 to 2014 increased by 8%. Total gross assets of private funds increased by nearly $1 trillion (totaling almost $10 trillion), and of those total gross assets, approximately $6.1 trillion was reported by hedge funds. Likewise, hedge funds had $3.4 trillion of the aggregate $6.7 trillion of private fund net assets at the end of 2014.

"Form PF data also allows the staff to monitor investment strategies among private funds and to understand the potential effects of certain market or global events," White clarified. "We have used it to assess funds' reliance on derivatives and leverage, their exposure to certain international markets, and their use of high frequency trading strategies."

However, with the establishment of the reporting infrastructure and commencement of the SEC's analysis of that data, the SEC is now focusing on making aggregate data from Form PF public. White mentioned the publication of the SEC's "Private Funds Statistics" report that provides certain aggregated and anonymized census data and statistics derived from Form PF data. "These statistics include, for example, the distribution of borrowings, an analysis of hedge fund gross notional exposure to net asset value, and a comparison of average hedge fund investor and hedge fund portfolio liquidity," she noted.

White discussed several industry trends illustrated by the data, including the following:

- Although the total notional value of derivatives reported on Form PF has increased (from about $13.6 trillion to about $14.8 trillion), that value has decreased relative to total net

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assets from the beginning of 2013 to the end of 2014, from about 256% of net asset value to about 221% of net asset value.

- More than half of all large hedge fund advisers report aggregate economic leverage less than two and a half times total reported hedge fund net assets.
- Fewer than 100 reporting hedge funds – representing less than $70 billion in combined net assets – employ high-frequency trading strategies for some portion of their funds.

Risks Beyond the Firm

"The data we are now receiving is giving us a better understanding of not only the risk profiles of individual firms, but also the broader fund industry and potentially the financial system as a whole," White said, arguing that addressing those risks is "fundamental to our long-standing mission to protect investors, maintain market integrity, and promote capital formation. Simply put, investors are not protected if broad and interconnected segments of the financial system are at risk."

She noted that private funds and their advisers play an important role in the financial system. There are approximately 2,600 private fund advisers, each managing over $150 million in private fund assets. Furthermore, private fund investors include individuals, pension plans and non-profit organizations, and large hedge funds turn over trillions of dollars in listed equity and futures transactions each month. "It is therefore natural for the characteristics of your funds – their leverage, their concentration, their size – to be of interest to the SEC and our fellow regulators," White asserted.

Risks Arising from Services and Activities

One insight White mentioned is that potential risks can cut across the asset management industry, arising from the services provided to investors and the activities of a range of financial market participants. She discussed FSOC's request for comment earlier this year that addressed the client services and activities of asset managers with vastly different profiles, noting that collaboration among regulators is essential for better coordinating their actions and closing any gaps in oversight.

The SEC is also proposing several measures to help ensure that regulation of investment advisers and mutual funds addresses the challenges and risks of the evolving marketplace. As examples, White highlighted the SEC's proposed new rules for liquidity management programs and swing pricing at mutual funds and the proposed extensive new data reporting requirements for registered funds and advisers.

Operational Risks

White also explained that operational risk, which can arise from inadequate or failed processes and systems that provide services to the adviser or funds, is another industry-wide risk on which the SEC is focusing. She then highlighted "three specific operational risks that merit close attention:"

1. *Operational risks surrounding transitions of client accounts to a new adviser.* SEC staff is developing recommendations to assist an investment adviser in assessing and planning for the impact on investors when it is no longer able to serve its clients. White mentioned that a

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clear, well-defined transition plan should address issues with liquidation of asset classes that are harder to sell; contractual rights of investors that other advisers may not be willing or able to accept (which may limit the adviser's ability to transfer management of or liquidate the fund without further action by the investors); and confidentiality concerns of investors.

2. *Cybersecurity*. As noted in SEC guidance earlier this year, advisers are encouraged to assess their ability to prevent, detect and respond to attacks in light of their compliance obligations under the federal securities laws. White encouraged the audience to "pay careful attention to the areas discussed in the guidance." See "SEC Guidance Update Suggests a Three-Step Framework for Investment Manager Cybersecurity Programs," Hedge Fund Law Report, Vol. 8, No. 18 (May 7, 2015). White also discussed the recent settlement by the SEC against investment adviser R.T. Jones Capital Equities Management, Inc. as an illustration of the problems investment advisers can face in the cybersecurity arena. See "Investment Adviser Penalized for Weak Cyber Policies; OCIE Issues Investor Alert," Hedge Fund Law Report, Vol. 8, No. 38 (Oct. 1, 2015). "Cybersecurity is the shared responsibility of all regulators and market participants, including investment advisers, to guard the broader financial system against intrusions. While cybersecurity attacks cannot be entirely eliminated, it is incumbent upon private fund advisers to employ robust, state-of-the-art plans to prevent, detect, and respond to such intrusions."
3. *Market Stress*. White reiterated that the SEC is considering ways to implement the Dodd-Frank requirements for annual stress testing by large registered investment advisers and registered funds, noting that international bodies such as IOSCO are also considering the same issues. "Our initial focus is on registered funds and their advisers, but there are important questions about how to address this issue for other registered advisers that meet the Dodd-Frank asset threshold, including private fund advisers," she said. A challenge in addressing this risk, however, is tailoring the SEC's implementation of this mandate to the specific risks and business models of diverse asset managers, White argued, noting that the traditional models of stress testing for banks and broker-dealers may not transfer to the industry. "It is too soon to draw any conclusions about what our stress tests will look like for advisers, but we have received some useful inputs from certain of the Form PF questions addressed to existing stress testing practices," White clarified, explaining that the SEC welcomes further input on how current approaches could be improved or standardized.

Changes in the Broader Regulatory Framework

Before turning to a discussion of firm-specific compliance risks, White then briefly discussed how shifts in the broader regulatory framework have affected private fund advisers. "Due in part to the renewed focus on systemic risk, there are a number of significant new rules in recent years that – while not directly applicable to private funds – have profound effects on them," she claimed.

The Volcker Rule is a "prime example" of this, White argued, as it had a significant impact on who can own and sponsor private funds, requiring some advisers to substantially alter their activities. Another example is clearing; while funds are generally not members of clearing agencies, the manner in which clearing agencies manage risks can nonetheless materially affect funds – such as through margin requirements, collateral protections and position portability.

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White postulated that, as regulators continue to focus on systemic risk, efforts like the above will likely continue to impact investment advisers.

Risks Within the Firm

The risks that mean the most to investors are "those close to home, tied to issues within a specific firm," claimed White, as she highlighted several recurring, specific compliance risks that should be addressed by each private fund adviser every day.

Calling it "the cornerstone of our regulatory framework for asset managers," White explained that fiduciary duty requires investment advisers to serve the best interests of their clients and seek to avoid, or at least fully disclose, conflicts of interest, including those related to organization, operation and management of client assets.

"This duty is the bulwark of investor protection," White stressed, but as part of the presence exam initiative last year, "our examiners identified several areas where cracks in this bulwark were found." She then identified the following areas of risk:

- *Marketing*. White noted that some hedge fund advisers may have used marketing materials that included back-tested performance numbers, portable performance numbers and benchmark comparisons without proper disclosure.
- *Disclosure of conflicts*. Some hedge fund advisers may not adequately disclose conflicts related to their proprietary funds and the personal accounts of their portfolio managers. For examples, profitable trades may be improperly allocated to proprietary accounts rather than to clients, in contravention of policies and procedures.
- *Fees and Expenses*. White discussed instances of conflicts involving fees and expenses among private equity advisers, including improper allocation of expenses away from the adviser and to the funds or portfolio companies. "Examiners also continue to observe advisers collecting millions of dollars in accelerated monitoring fees without disclosing the practice," she noted. See "Blackstone Settles SEC Charges Over Undisclosed Fee Practices," Hedge Fund Law Report, Vol. 8, No. 41 (Oct. 22, 2015). White clarified that these fee and expense observations go beyond private equity advisers; for example, the Private Funds Unit in OCIE is reviewing private fund real estate advisers who may be hiring related parties without proper disclosure.

In addition to the foregoing, White urged the audience to focus on recent SEC enforcement actions centering on disclosure and conflicts of interest, including actions against Kohlberg Kravis Roberts & Co.; Guggenheim Partners Investment Management; Alpha Titans; and three investment advisers affiliated with The Blackstone Group.

"These cases underscore the value of our oversight and exam program, which identifies practices that would have been difficult for investors to discover by themselves," White claimed, noting that they also illustrate the need for investment advisers to disclose material facts to clients. "Investors, regardless of their sophistication level, must have, and deserve to have, the information necessary about their adviser and funds to make an informed investment decision – including their adviser's actual or potential conflicts of interests."

Conclusion

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In conclusion, White noted that, as the industry moves beyond the initial phase of post-Dodd-Frank rules, "it is essential that we continue to work together to build a strong regulatory framework that addresses both these firm-specific risks and the risks that can have an impact on the broader financial system."

She argued that these risks are intertwined, and a strong compliance culture is fundamental to the strength of the industry and its ability to work with regulators, investors and others to foster a robust, resilient financial system.

"Five years on, while the intensity of the specific changes precipitated by the Dodd-Frank Act may have lessened, we have continued to build a strong regulatory framework that protects investors while preserving the vibrant diversity of private funds," White claimed in closing. "I believe that the next five years must do the same."

To view the complete speech, click here.

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