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Examinations

Hedge Fund Managers Advised to Prepare for Imminent SEC Examination

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By Jennifer Banzaca, *Hedge Fund Law Report*

As it pursues its "broken windows" approach to enforcement, the SEC has filed a record number of actions against hedge fund managers and investment advisers. Faced with this increased regulatory scrutiny, managers – both emerging and established – need to be cognizant of and prepared for aggressive inspection by regulators, as well as possible enforcement action.

Among other topics, speakers at the annual Sadis & Goldberg Alternative Investment Seminar addressed the issue of increased regulatory scrutiny and how hedge fund managers can prepare for SEC examinations and investigations. This article summarizes the salient points made during the discussion.

For more from Sadis & Goldberg, see "Practitioners Discuss U.S. and Canadian Shareholder Activism and Activist Tools" (Dec. 4, 2014); and "Tax Efficient Hedge Fund Structuring in Anticipation of the New 3.8% Surtax on Net Investment Income and Proposals to Limit Individuals' Tax Deductions" (Oct. 18, 2012).

SEC Examination Concerns

In today's strict regulatory environment, hedge fund managers should operate at all times as though the SEC will arrive to conduct an onsite examination at any second. The SEC has used its examinations as a tool to uncover inconsistencies, questionable practices or illegal activities that lead to enforcement actions. With this in mind, hedge fund managers need to be prepared for SEC examinations. See "OCIE Outlines Examination Priorities for 2016" (Jan. 14, 2016).

The SEC has been much more active in recent years, noted Sadis & Goldberg partner Douglas Hirsch. "Since Madoff, there has been incredible pressure on the SEC from Congress to bring more actions, to be more aggressive and to put more of the bad actors on Wall Street out of business through criminal actions and working with the Justice Department."

Hirsch pointed out that the number of SEC enforcement actions has increased significantly, arguing that circumstantial evidence suggests that the SEC is bringing weaker cases to enforcement. "In 2007, there were 655 enforcement actions," he explained, "and since then, they have increased the number of enforcement actions tremendously. In 2015, there were 807 enforcement actions."

With the SEC more aggressively bringing enforcement actions, it is not enough for hedge fund managers to be prepared for an examination; they also need to know what to do during an investigation. In fact, managers should be able to deal with regulators from inception to possible

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investigation. As Sadis & Goldberg partner Sam Lieberman explained, “We live in an era where the SEC is defined by a culture of enforcement. What that means is that each time you’re dealing with the SEC these days, there is more money at stake than there ever has been before.”

“Each time you come into contact with the SEC, you’re dealing with a regulator that is thinking about what enforcement action could be brought against you,” Lieberman warned. Consequently, he advised managers in the early stages of interaction – such as registration – to already think about the examination stage. “You also want to think about what happens if you’re unfortunate enough to be part of an SEC investigation,” he advised. “You really need to be prepared for every possible outcome right from the outset.”

Lieberman said that in the past, managers may have had an opportunity between the registration stage and an examination to cure incorrect disclosures in the Form ADV or other regulatory filings. “Now, that is a new enforcement action that can be brought against you.”

The tenor of exams and inspections by the SEC’s Office of Compliance Inspections and Examinations (OCIE) has also changed, Lieberman noted. “Right now, the SEC is putting out press releases for enforcement actions where it thanks OCIE for helping bring the case. The problem is, that’s not OCIE’s job; their job is to conduct exams to help you get things right.”

Whereas hedge fund managers may expect to receive an opportunity to address any issues raised by way of a deficiency response, Lieberman countered that this opportunity is frequently unavailable. “You’re given a deficiency letter, and enforcement arrives at your door shortly after. This makes it more important to have a lawyer or compliance consultant preparing your people for your response.”

Lieberman clarified that cases against chief compliance officers (CCOs) for providing apparently false responses to regulators at the exam stage are increasing. Likewise, he noted, “we’re seeing situations where people are being faulted for not giving enough to compliance. I think it’s really important early on to get your lawyer involved because there is a lot at stake.” See “SEC Enforcement Action Shows Hedge Fund Managers May Be Liable for Failing to Adequately Support Their CCOs” (Jul. 23, 2015).

Preparation for SEC Examinations and Investigations

Sadis & Goldberg partner Daniel Viola added that there has been a change in the culture of exams. “The SEC has become more aggressive and smarter. More than ever, the SEC is going to know a lot about your firm before they arrive. There is now more of a burden on compliance staff to dedicate additional resources and to be mindful if you are wearing multiple hats, as this is a hotbed of risks for the SEC.”

Because of this culture of enforcement at the SEC, managers need to be prepared heading into examinations and investigations. “When you get to the early stage of an investigation, this is where the battle is won, and you really need to get your arms around the facts,” Viola explained.

“In addition to having all your ducks in a row and having a strong culture of compliance,” Hirsch added, “you can have an insurance policy in place that will provide for defense costs. Defending these actions can cost millions of dollars. If the SEC sees that you are prepared to fight them, you will almost always get a better result.” For more on insurance, see “Costs and Structures of Hedge Fund Management Liability Insurance Policies” (Jun. 11, 2015).

Being prepared for examinations and investigations means making sure employees fully comprehend the firm’s policies, procedures and disclosures so they do not provide

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misinformation if interviewed by OCIE staff. Lieberman cautioned that the SEC may deploy a "perjury trap" – consulting with "smart, experienced people" who test a hedge fund manager's credibility by asking a series of questions to which they already know the answers. "When you give an incorrect response or something that is not entirely in line with the information they already have, the SEC makes a snap judgement about the compliance culture at your firm and could come after you based solely on that one response," he warned.

Some key steps to preparing for an SEC examination or investigation include:

- Make sure you manage and dedicate the right resources to strong compliance.
- Be prepared for the SEC exam. Don't wait for the last minute to get ready. Get a copy of the document request lists, and conduct a mock exam.
- Confirm that all disclosure is proper. The hedge fund's offering documents and the manager's Form ADV have to be consistent.
- Ensure your valuation practices are consistent.
- Prepare for your compliance exams.
- When the SEC comes to visit, contact your lawyer and review your insurance policies.

See also "How Can Hedge Fund Managers Prepare for an SEC Investigation and Maximize the Odds of Obtaining Insurance Coverage? (Part One of Two)" (May 16, 2013).

Insider Trading

Viola noted that the biggest development in insider trading cases was the U.S. Court of Appeals' reversal of the convictions of Todd Newman and Anthony Chiasson, remote tippees who had traded on material nonpublic information about Dell and Nvidia. See "Second Circuit Overturns Newman and Chiasson Convictions, Raising Government's Burden of Proof in Tippee Liability Insider Trading Cases" (Dec. 18, 2014); and "Supreme Court's Denial of Cert in *Newman* Complicates Insider Trading Prosecution (Part Two of Two)" (Nov. 5, 2015).

"The SEC constantly takes the incorrect view that trading on material nonpublic information by itself is insider trading," Hirsch said. "That is false. There are other elements that must be proven, such as a breach of fiduciary duty by the tipper."

Conflicts of Interest

The SEC's Asset Management Unit remains focused on conflicts of interest, particularly those related to valuation and fees and expenses. See "Current and Former SEC, DOJ and NY State Attorney General Practitioners Discuss Regulatory and Enforcement Priorities" (Jan. 14, 2016). When it comes to conflicts of interest, managers must disclose conflicts to their investors.

As Lieberman noted, managers need to focus on avoiding potential conflicts of interest. "There have been some seminal cases involving strict liability of the CCO, so you need to focus on where your conflicts are. You need to carefully monitor fee structures, charging of expenses and other issues to ensure there is no favoritism or fiduciary duty violations." For more on CCO liability, see "SEC Enforcement Director Assures CCOs They Need Not Fear SEC Action Absent Wrongdoing" (Nov. 19, 2015).

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