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SEC Enforcement Matters

Will Inadequate Policies and Procedures Be the Next Major Focus for SEC Enforcement Actions?

Nov. 30, 2017

By Michael Washburn, *Hedge Fund Law Report*

The SEC has taken recent enforcement action against Deerfield Capital Management (Deerfield), Artis Capital Management (Artis) and R.T. Jones Capital Equities Management (R.T. Jones) for failing to maintain policies and procedures tailored to the risks of their respective operations. Although the areas of deficiency in question vary widely – from protocols for handling material nonpublic information (MNPI), in the cases of Deerfield and Artis, to cybersecurity defenses, in the case of R.T. Jones – the respondents in one way or another all found themselves in trouble for allegedly failing to maintain and enforce "reasonably designed" policies and procedures.

Despite expectations that the SEC, under new leadership, would reduce the "broken windows" approach to enforcement, some believe these three cases are harbingers rather than history and that they foreshadow the deployment of the dramatically expanded resources available to the SEC's Office of Compliance Inspections and Examinations (OCIE) for investment adviser examinations in a broad effort to ensure that firms maintain appropriately tailored policies and procedures, as well as oversee employees in sensitive areas of their operations. As SEC Chair Jay Clayton recently told the Hedge Fund Law Report, "looking at firms' policies and procedures will continue to be a priority for the Commission."

To help readers understand this trend, adopt best practices and insulate themselves against enforcement actions similar to those named above, the HFLR has interviewed legal professionals with expertise in regulatory enforcement matters. This article presents the insights from those interviews, along with Clayton's further thoughts on the matter.

For analysis of the Deerfield, Artis and R.T. Jones cases, respectively, see "Hedge Fund Manager Deerfield Fined $4.7 Million for Failing to Adopt Insider Trading Compliance Policies Tailored to the Firm's Specific Risks" (Sep. 21, 2017); "General Insider Trading Policies and Procedures May Be Insufficient for Hedge Fund Managers to Avert SEC Enforcement Action" (Nov. 3, 2016); and "Investment Adviser Penalized for Weak Cyber Policies; OCIE Issues Investor Alert" (Oct. 1, 2015).

Mixed Message From the Regulators

Some signals coming from the regulators may appear, at first glance, to convey a more lenient and permissive approach in keeping with the generally stated pro-business stance of the Donald J. Trump administration. A top official at the Commission, Division of Enforcement Co-

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Director Steven Peikin, recently stated that the SEC would move away from the broken-windows policy articulated by former Chair Mary Jo White.

It remains to be seen, however, what this will mean in practice, noted Jonathan Forman, counsel at BakerHostetler. For advisers to take any comfort in Peikin's statement would be premature. Irrespective of recent public statements, OCIE has stepped up examinations of advisers.

"As far as insider trading cases go, those cases will continue to be a big part of the SEC's enforcement agenda because they fit within Chair Clayton's focus on securities fraud violations that affect market integrity," Forman continued. "Those types of cases also are more easily prosecuted these days with the various data analytics the SEC is now utilizing."

Across the U.S., OCIE staff have transferred from the broker-dealer side to the adviser side, noted K&L Gates partner Vince Martinez. As the SEC strives to concentrate its resources on adviser examinations, it follows logically that more examinations in this space are on the way. "I believe there is a pattern, and I have been advising folks to expect the SEC to become more insistent that policies and procedures need to be tailored to the business at issue," Martinez said.

SEC Chair Jay Clayton recently echoed this observation, telling the HFLR that part of regulation is for those who are regulated to demonstrate that they are complying. "One of the best ways to demonstrate that you are complying is to have policies and procedures that you follow," Clayton continued. "When [the SEC] writes regulations, we want to write them in a way that people can efficiently demonstrate [compliance] and effectively comply. And so yes, policies and procedures, and looking at firms' policies and procedures, will continue to be a priority for the Commission."

More Enforcement Actions Likely

The tendencies of the regulators are best understood with a broad perspective on developments in the financial and funds sectors in recent years, stressed Charles Whitehead, a professor at Cornell Law School. After the passage of the Dodd-Frank Act in July 2010, many unregistered and unregulated advisers were suddenly subject to regulation, and new registrants were concerned they lacked the internal policies and procedures necessary to meet their compliance obligations.

Fortunately for private fund advisers, the SEC at that time was overextended and tended to direct its resources toward broad market stability issues that had come to light as a result of the financial crisis, Whitehead argued. Therefore, the agency's staff did not direct resources to auditing or regulating advisers in the expected manner. All of this is changing now as the financial crisis fades into the past and the division of OCIE devoted to examining advisers bulks up.

"What you may now be seeing, because of a change in focus, is a catch-up," Whitehead said. "The SEC may look to review investment advisers in a way it has not done in the past, and without basic procedures in place, advisers may face further compliance issues."

Changing Stance of the Regulators

Although regulators still tend to reserve enforcement actions for highly specific sets of circumstances, any optimism about the regulators' tendencies under the new administration must be guarded. Rhetoric notwithstanding, enforcement staff are growing more particular with regard to the quality of policies and procedures that examinees have in place, Martinez observed. Examiners are adamant that red flags not be ignored, as occurred in the case of R.T.

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Jones, whose website came under attack in July 2013 after the firm allegedly failed to maintain written policies and procedures designed to avert cyber breaches.

"The regulators have more time and bandwidth, so they are becoming more demanding. What that means for advisers is that they need to understand the unique risks of their businesses," Martinez commented.

It is impossible to view the SEC's vigilance toward inadequate policies and procedures in isolation from the developing technologies at the Commission's disposal. When probing for trading violations, for example, examiners today are able not only to review trading records but also to compare the records against those of other traders and similar events. In addition, they can compare an individual trader's history against those of the trader's peers to detect statistical anomalies in winning trades. The regulators, therefore, can discover patterns and anomalies that a single transaction would not divulge, Martinez noted.

"A big gain right after an acquisition is not the only thing that will trigger the SEC's scrutiny of insider trading," Martinez continued. "It can be a set of trades over time indicative of access to MNPI, even if that MNPI is not being exploited fully for every trade."

In light of this reality, it is critical for advisers to scrutinize the trading of their own personnel to determine whether they are winning all the time. Advisers must also review their investments and carefully consider whether a source of MNPI could potentially play any role in the results.

Lack of Clear Guidance?

Unfortunately, the regulators' insistence on the tailoring of policies and procedures is not matched by clear and consistent guidance on how to achieve this goal, Martinez observed, citing Rule 30 under Regulation S-P as an example. The rule states simply that a registrant needs to have policies and procedures "reasonably designed" to protect customer information. A number of provisions of the Investment Advisers Act of 1940 and its rules make similar use of principles-based guidance.

"Sometimes, the requirements of principles-based regulations are defined through enforcement actions, which some have found to be unfair," Martinez commented. It is entirely feasible for the Division of Enforcement staff to address concerns of this nature, however, by developing a record that will show that a registrant failed to exercise due care and acted negligently.

"If the staff finds shortcomings in a registrant's policies and procedures, the analysis as to how egregious those shortcomings are can be subjective. But, there are certain hallmarks that registrants should be cognizant of. If one has a deficiency that has not been cured, then the next time OCIE visits, the issue is more likely to be ripe for enforcement," Martinez added.

If it emerges that a registrant has ignored certain deficiencies, this finding may well become the basis for an enforcement action, Martinez continued. This is what happened in the R.T. Jones matter and other cybersecurity cases, he said.

What to Watch Out For

Preventing compliance deficiencies and avoiding enforcement actions are virtually impossible if an organization abdicates its responsibility to implement and oversee compliance from the top,

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said Ben Kozinn, a partner at Lowenstein Sandler. The Deerfield matter provides an example of the type of deficiency that the agency has in its crosshairs.

Characterizing the central issue at Deerfield as a "tone from the top" issue, Kozinn noted that analysts at the firm did not feel the necessity to report any potential problems they spotted, because the pressure for returns was stronger than the pressure to meet compliance obligations.

"When interacting with research firms, it was completely on the employees to determine whether they were in possession of MNPI or in a situation in which MNPI might be exchanged and needed to be verified by the compliance department," concurred Forman. "Had compliance oversight been implemented, a number of red flags would have been raised, requiring them to undertake a little more work to make sure that the information exchanged could be traded on."

To avoid this type of situation, Kozinn said, it is critical not just to recognize instances where employees could gain exposure to MNPI, but also to have reasonably designed internal oversight of employees and avoid leaving it to them to self-identify and self-report potential issues.

For further insight from Kozinn on insider trading, see "In U.S. *v. Martoma*, Second Circuit Eliminates 'Meaningfully Close Personal Relationship' Element Articulated in *Newman* for Insider Trading Prosecutions" (Sep. 14, 2017).

What Are "Reasonably Designed" Policies?

One of the most common sources of a compliance deficiency is a firm's protocol, or lack thereof, for the handling of MNPI. More enforcement actions are not just likely but inevitable in the absence of policies and procedures reasonably designed to prevent the misuse of MNPI, and here advisers face what may seem an extremely daunting task.

Noting that investment firms are in the business of culling data from a number of different sources, analyzing the information and making decisions on the basis of it, Kozinn acknowledged the wide variety of possible sources of information. These range from obvious sources, including press reports, SEC filings or similar filings by non-U.S. issuers, to less traditional research originating from expert networks, political consultants and big data. All of that information, and the manner in which firms gather it, has the potential to contain or be wholly composed of MNPI.

See "Tips and Warnings for Navigating the Big Data Minefield" (Jul. 13, 2017); and "Best Practices for Private Fund Advisers to Manage the Risks of Big Data and Web Scraping" (Jun. 15, 2017).

"Whenever you have a real risk that someone you're talking to outside the firm could provide someone inside the firm with MNPI, you need to understand the provenance of information that is being provided to you," Kozinn said. "You also need to have a process for understanding that firm's compliance regime and ensuring that the firm understands that it is dealing with an investment firm making decisions on the basis of information being provided to it from various sources. You must also ensure that the firm has controls in place designed to prevent sharing MNPI with employees of investment firms."

For insight on designing policies and procedures to prevent insider trading, see "K&L Gates Partners Identify Eight Actions That Hedge Fund Managers Can Take to Avoid Insider Trading Violations (Part Two of Three)" (Nov. 20, 2014).

Understanding the Risks

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It may be difficult to compare the relative risks of one service provider to another on a global basis, Kozinn conceded. Some will naturally pose more risk than others. It is ultimately necessary for a firm to make decisions about its risk tolerance and to assess the riskiness of a given service provider that is funneling information to the firm.

"To say that you can treat a given service provider differently creates dangers that you are not going to monitor the information correctly, however," Kozinn cautioned. See "How Fund Managers Can Develop an Effective Third-Party Management Program" (Sep. 21, 2017).

The critical task is for a firm to know to whom its personnel are talking and what is being done with the information they receive. General counsels and chief compliance officers must understand not only the type of information or research being transmitted to investment analysts at their respective firms, but also how the data have been obtained. It is important to chaperone these meetings, or at least make sure that the proceedings are entered into a log.

"You need to monitor people's communications following those meetings, as well as run testing on when those communications took place relative to trading activity and whether there was P&L shortly after the communications took place," Kozinn advised. "If you have red flags, and you've seen email or trading activity following these meetings, you need to press the pause button and look more closely."

For more on chaperoning research calls, see our three-part series: "Whether Hedge Fund Managers Should Chaperone Primary Research Calls" (Sep. 17, 2015); "Considerations in Implementing a Chaperoning Program" (Sep. 24, 2015); and "Challenges in Implementing a Chaperoning Program" (Oct. 1, 2015).

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