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CONFLICTS OF INTEREST

Seward & Kissel Private Funds Forum Explains How Managers Can Prevent Conflicts of Interest and Foster an Environment of Compliance to Reduce Whistleblowing and Avoid Insider Trading (Part Two of Two)

By Michael Washburn

The SEC has recently pursued significant enforcement actions for conflict of interest and insider trading violations, in addition to matters brought via the whistleblower program introduced in 2010 under the Dodd-Frank Act. In response to these recent regulatory developments, it is more important than ever for fund managers to implement safeguards to avoid becoming subject to SEC scrutiny. These issues, and practical measures that fund managers can adopt accordingly, were among the items addressed by a panel at the second annual Private Funds Forum produced by Seward & Kissel and Bloomberg BNA, held on September 15, 2016.

Moderated by Seward & Kissel partner Patricia Poglinco, the panel included Laura Roche, chief operating officer and chief financial officer at Roystone Capital Management; Scott Sherman, general counsel at Tiger Management; and Rita Glavin and Joseph Morrissey, partners at Seward & Kissel. This second article in a two-part series explores the SEC's targeting of various conflict of interest scenarios, provides an overview of the status of the SEC's whistleblower program and examines the difficulty of prosecuting insider trading. The first article addressed the inflow and outflow of material nonpublic information, risks related thereto and the ways that fund managers can ensure it is not improperly used.

For additional insight from Seward & Kissel attorneys, see "*What D&O and E&O Insurance Will and Will Not Cover, and Other Hot Topics in the Hedge Fund Insurance Market*" (Jul. 14, 2016); and "*The First Steps to Take When Joining the Rush to Offer Registered Liquid Alternative Funds*" (Nov. 6, 2014). For commentary from Poglinco, see "*How Studying SEC Enforcement Trends Can Help Hedge Fund Managers Prepare for SEC Examinations and Investigations*" (Sep. 8, 2016). For more from Sherman, see "*RCA Symposium Clarifies Current Market Practice on Side Letters, Conflicts of Interest, Insider Trading Investigations, Whistleblowers, FATCA and Use of Managed Accounts Versus Funds of One (Part One of Two)*" (Jun. 13, 2013).

Disclosing Conflicts of Interest

Investors As Arbiters

When it comes to disclosure of conflicts of interest – a particularly hot-button enforcement issue – it is useful to look from the perspective of the regulators in charge of bringing enforcement actions. "Regulators view conflicts of interest as existing when a manager has some interest, other than the client's interest, which weighs on its own judgment," explained Morrissey. In such conflict of interest scenarios, "regulators are not comfortable with the manager making its own judgment that an activity is proper," he continued. See also "*Former SEC Asset Management Unit Co-Chief Describes the Agency's Focus on Conflicts of Interests and Increased Efforts to Crack Down on Private Fund Managers*" (Sep. 15, 2016).

A key takeaway from the SEC's recent public statements on the subject, Morrissey explained, is that disclosure to investors of such conflicts of interest needs to be detailed and specific. "Clients should be deciding if a conflicted scenario is proper, based on having had full and clear disclosure regarding the conflict, including what, if any, steps have been put in place to control or mitigate it," he continued. See "*SEC Division Heads Enumerate Enforcement Priorities, Including Conflicts of Interest, Valuation, Performance Advertising and CCO Liability (Part Two of Two)*" (May 5, 2016).

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If the client, acting with its eyes wide open, decides to accept that conflict, then it should pass muster with the regulators, Morrissey said. However, if the manager has not disclosed the conflict clearly enough for a reasonable investor to make that determination, then there may be a violation from the SEC's perspective.

Collaborative Action

Sherman emphasized the need for a collaborative approach. "First and foremost, it is critical to understand that this is a team effort," he said, "and everybody in your firm needs to be involved."

For example, fees and expenses are a hot-button issue at the moment. It is important to sit down with the CFO and accounting team to ensure there is a mutual understanding of which expenses are being charged to funds, how they are being allocated and what other underlying processes are in place with respect to the allocations. "It's also important to involve your administrator in the discussion," Sherman added, "because they have a role there as well."

Allocation and valuation policies are another area of focus, Sherman continued. He emphasized the importance of speaking with the CFO about how investment opportunities are allocated and the policies behind those allocations to ensure disclosures accurately reflect those practices. "It's literally a matter of going into each area of the firm and understanding every process they undertake," he explained.

As managers undertake this review of processes, Sherman also explained that they need to make sure that they "identify all the conflicts, attempt to identify ways to mitigate those conflicts and ultimately provide adequate disclosure around them." In order to identify conflicts of interest, a manager must look carefully at questions such as whether there are fee differentials between two accounts and whether the existence of those differentials gives the manager an incentive to allocate positions a certain way. The determination that the manager makes upon carefully considering these questions must inform its disclosures.

Speaking from her perspective as a chief operating officer and chief financial officer of a private fund manager, Roche identified certain issues where fund managers can get tripped up if they are not careful. "Management fee and incentive fee structures are getting increasingly complicated as there is more pressure on the industry," she clarified. "The chief compliance officer should sit with the accounting team and not just take for granted that they understand how it's done correctly."

See "*RCA Compliance, Risk and Enforcement Symposium Examines Ways for Hedge Fund Managers to Mitigate Conflicts of Interest*" (Jan. 21, 2016); and "*Proper Use of Advisory Committees by Private Fund Managers May Mitigate Conflicts of Interest*" (Dec. 17, 2015).

Coming to Grips With the Whistleblower Program

Growth of the Program Since Its Inception

Glavin addressed recent trends within the SEC's enforcement division, a speech given on September 14, 2016, by Andrew Ceresney, Director of the agency's Division of Enforcement, and the weight that the agency has given in the last few years to information reported by whistleblowers. For more from Ceresney, see "*SEC Enforcement Director Highlights Increased Focus on Undisclosed Private Equity Fees and Expenses*" (May 19, 2016); and "*SEC Enforcement Director Assures CCOs They Need Not Fear SEC Action Absent Wrongdoing*" (Nov. 19, 2015).

The SEC is operating with a new office – the Office of Market Intelligence – that works in conjunction with the Office of the Whistleblower, Glavin noted. "The whistleblower program has been the greatest gift to the SEC and to the Department of Justice," she said, linking the success of the program to the huge incentives it offers to whistleblowers who provide tips leading to successful enforcement actions.

Under Section 922 of the Dodd-Frank Act, a whistleblower is eligible to receive between 10 and 30 percent of the fine the SEC levies for a violation

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of the securities laws, Glavin explained. Consequently, the incentive for a competitor or disgruntled former employee to report any slight variance or suspicious activity to the SEC is huge – analogous to winning the lottery, she said.

In an actual case ten years ago, the SEC and DOJ settled an enforcement action for $1 billion, Glavin noted the whistleblower was entitled to receive 30 percent, or $300 million, of that amount. In view of the potential rewards, it is unsurprising that regulators have received 14,000 tips since 2011 – with 4,000 coming in 2015 alone – and that a veritable "cottage industry" has sprung up of lawyers willing to represent whistleblowers.

Raising a point that some may have missed amid all the publicity about the whistleblower program, Glavin added that "out of the 14,000 tips received, the SEC is not telling which ones had no merit or what rabbit holes they went down only to find nothing inside." Indeed, given the potential rewards, it is possible or even probable that large numbers of tips may be without merit and may have arisen from purely selfish motives.

Private Industry Response to Whistleblowing

One byproduct of the nature of the whistleblower program is that it puts companies at a considerable disadvantage in their encounters with regulators resulting from these tips. "Because a whistleblower is anonymous," Glavin commented, "you won't necessarily know where he or she came from, particularly if it's a former employee. The SEC will get the tip and conduct a little due diligence to decide if a subpoena or document request is worthwhile."

Consequently, a manager may be unable to figure out what the SEC is investigating. The SEC may not tell the manager explicitly, Glavin added, even if it is clear that it is looking for something.

In one case with which Glavin was involved, she said there was little merit to the allegations. But everyone has an incentive to go to the government because of the reward, while a similar incentive may be lacking to go through compliance channels of a firm and report a violation internally before going to the SEC. To highlight this point, she described a $22 million payout to a whistleblower earlier this year and the fact that the agency has attributed $500 million in sanctions to its whistleblower program.

If a firm has a compliance program and wants to minimize the risk of whistleblowers, Glavin suggested that it use a "broken windows" approach to try to dissuade its current and former employees from blowing the whistle. If, as the SEC maintains, no violation is too small to report, then a firm can prevent violations from blowing up and leading to costly enforcement actions by rooting out irregularities at its very lowest levels. This is premised on the theory that stopping small violations has a general effect of fostering a culture of compliance with the law and preventing bigger crimes.

See "*How Hedge Fund Managers Can Balance Protecting Confidential Information Against Complying With Whistleblower Laws*" (Aug. 25, 2016); "*How Promoting Internal Reporting Can Reduce Risk of Regulatory Intervention for Hedge Fund Managers*" (Aug. 11, 2016); and "*RCA Session Offers Insights on Dodd-Frank Whistleblower Regime, Incentives, Anti-Retaliation Protections and Risks*" (Apr. 9, 2015).

Complications of Prosecuting Insider Trading

Firms handling sensitive information are operating in a complex environment where legal standards as to what constitutes insider trading are not as clear-cut as they once were. The panelists identified several aspects of alleged insider trading cases that might make it harder, at least for some observers, to judge whether insider trading actually occurred.

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When the U.S. Court of Appeals for the Second Circuit issued its landmark decision in U.S. v. Newman, the two individuals charged were not directors of the company but a couple of levels down from the top. The Second Circuit overturned their conviction on the basis that they did not know the source of the MNPI, so there was no breach of fiduciary duty.

Newman illustrates the necessity of showing that there was some benefit to the person who received the information. Notwithstanding this ruling, questions continue about who benefitted from the MNPI, whether the alleged benefit was substantial, what the participants knew and what the intent behind their actions was. See "*The Newman/Chiasson Decision Continues to Have Implications for Insider Trading Compliance*" (Apr. 30, 2015); and our two part series on the "*Supreme Court's Denial of Cert in Newman": Part One* (Oct. 29, 2015); and *Part Two* (Nov. 5, 2015).

Besides Newman, there are a number of cases where an insider gave information to a friend with the understanding that the friend would not disclose it to anybody, with the friend then disclosing the information, Glavin explained. Regulators continue to bring these cases, but in light of Newman they may do significantly more investigating for the purpose of determining who benefited and whether the alleged violation meets current standards as to what constitutes a "tipper/tippee" scenario. A Supreme Court decision expected later this year may shed more light on this issue.

For fund managers, Glavin opined that these recent developments should not change much in practice. "You're still going to do the same trading," she said, "If you're getting into the minutiae of who gave a gift to whom, that will be after an investigation that has cost you millions of dollars in outside counsel legal fees." Although a fund manager may be correct under the law, Glavin speculated that most would not want to be "close enough to the line" to draw an investigation, resulting in additional legal expense and possible SEC enforcement action even if there is no criminal case.

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