

EXAMINATIONS

How Studying SEC Enforcement Trends Can Help Hedge Fund Managers Prepare for SEC Examinations and Investigations

By Michael Washburn

In a recent interview with The Hedge Fund Law Report, Patricia A. Poglinco and Robert G. Van Grover, partners at Seward & Kissel, discussed the types of activities the SEC is targeting when bringing enforcement actions against hedge and other fund managers. They also explored the evolving nature of SEC investigations and what hedge fund managers can do to prepare for these examinations. These are among the issues that Poglinco and Van Grover will explore in greater depth as they each moderate panels at the upcoming "Private Funds Forum" co-hosted by Seward & Kissel and Bloomberg BNA to be held on September 15, 2016.

For additional insight from Poglinco, see "*How Do Regulatory Investigations Affect the Hedge Fund Audit Process, Investor Redemptions, Reporting of Loss Contingencies and Management Representation Letters?*" (Jan. 22, 2015). For commentary from Van Grover, see "*Are Hedge Fund Managers Required to Disclose the Existence or Outcome of Regulatory Examinations to Current or Potential Investors?*" (Sep. 16, 2011); "*Implications for Hedge Fund Managers of Recent Insider Trading Enforcement Initiatives (Part One of Three)*" (Feb. 25, 2011); and our three-part series entitled "*How Can Hedge Fund Managers Structure Their In-House Marketing Activities to Avoid a Broker Registration Requirement?*": *Part One* (Sep. 12, 2013); *Part Two* (Sep. 19, 2013); and *Part Three* (Sep. 26, 2013).

HFLR: Chair Mary Jo White of the SEC recently announced the doubling of enforcement staff devoted to the private funds space. What do you see as the issues and challenges most directly motivating this stepped-up enforcement effort?

Poglinco: In terms of Chair White's recent statement about increasing examination staff, the SEC must be

of the view that there's more potential in this area. To date, the SEC has shaken up the private equity industry and seems intent on doing the same for the rest of the private funds industry.

A huge challenge is the impact of whistleblowers. I think whistleblowers have emerged as a very big factor in the way government goes about investigating issues, and fund managers have begun to give more thought to these issues. In my panel at the forum, we're going to talk about some of the recent statistics and cases which have caused us to advise clients, "if you haven't been paying attention, now's the time; these are very real tools of regulatory agencies." We think this is something people should be worried about.

We can also draw lessons and examples from recent SEC enforcement actions in the private fund areas. Conflict of interest issues continue to be an area of focus for the SEC. We've also seen this in the SEC Office of Compliance Inspections and Examinations (OCIE). There's been a lot of focus on disclosure of conflicts. The SEC has been really drilling into is what it thinks qualifies as "effective disclosure." It's not enough to identify and disclose a conflict of interest; the disclosure of the conflict has to be effective.

HFLR: What are some other areas where you've seen increased vigilance by regulators?

Poglinco: One other area that I think has been a recent focus of the SEC is operational risk. If you look at the business continuity and transition rule proposal that was recently issued by the SEC, it's clear that there is a focus on operational risk as a compliance issue. I'm not sure it's something people in the compliance or legal area really think about – that the SEC is viewing this issue from the standpoint of the fiduciary duty of a fund manager.

In the current enforcement environment, we also need to look carefully at post-Newman insider trading. [See *"SEC Continues to Focus on Insider Trading and Fund Valuation"* (Jun. 30, 2016); and *"Current and Former SEC, DOJ and NY State Attorney General Practitioners Discuss Regulatory and Enforcement Priorities"* (Jan. 14, 2016).] People looking at the situation may think there may be less of a risk, but we don't see that as the case.

On a practical level, over the past few years we have had a view into a significant number of SEC exams. We have a big client base of registered advisers, and we've seen an escalation of issues raised in the exam setting on a much quicker timeframe than we've ever experienced in the past. A lot of issues go to deficiency letters even though remedial or corrective measures have been taken. [See *"Three Steps in Responding to an SEC Examination Deficiency Letter and Other Practical Guidance for Hedge Fund Managers from SEC Veteran and Sutherland Partner John Walsh"* (Feb. 13, 2014).]

Our experience is that issues are identified in the exam setting, deficiency letters are fairly pointed and there is no hesitation to move things to enforcement. SEC examinations are a high-risk exercise. Advisers have to be thinking along those lines, be very reactive when issues come up and be strategic in the way they deal with an exam. [See *"Practical Guidance From Former SEC Examiners on Preparing for and Surviving SEC Examinations"* (Sep. 1, 2016).]

HFLR: Are conflicts of interest still an appropriate "overarching concern" for the Asset Management Unit of the SEC and the funds sector in general?

Van Grover: I would say that conflicts of interest are, and will remain, an important issue, and I think that the issue is broad and sweeping. An example of this can be found in the SEC's focus on expense allocations. The issue involves the misalignment of the manager's and clients' interests and the adequacy of disclosure. Often, there are questions raised about whether the specific disclosure is effective.

I think this issue will be with us for some time to come. This is because it goes straight to the SEC's focus on fiduciary duty. It's where managers' interests might conflict that the SEC sees the greatest possibility for something to go wrong or for the client to be harmed.

Poglinco: I don't think we're going to see diminished focus on conflicts of interest for some time. There will always be an interest in it, and when you look at big areas – expense allocation, outside business activity, personal trading – those are all conflict of interest issues.

HFLR: The International Limited Partners Association has developed a standard template for general partners to provide information about fees and expenses to investors. [See "How Managers May Address Increasing Demands of Limited Partners for Standardized Reporting of Fund Fees and Expenses" (Sep. 1, 2016).] Can we expect to see it widely implemented?

Van Grover: In terms of any industry standard, it's going to depend on the applicability to a particular situation and whether it is broadly adopted by investors. But when you look at standardized models for reporting performance, there are a lot of managers and individuals that think having a single way to look at something across different managers can be helpful. The answer is that the standardized reporting model could be successful if it is fulsome enough to take into account different strategies and the manner in which time horizons come into play.

Conversely, when you look at some of the side letters where large institutions require pages and pages of printouts in order to assess an investment, many family offices and high net worth individuals would find that amount of information cumbersome and unhelpful. So while coming up with a standard for everyone would be viewed by managers as a good thing, I think finding that standard – a balance – is difficult.

Poglinco: It's very complicated to get there, but there's no question that it would be useful. It's also difficult in the current regulatory environment, because when responding to the SEC's agenda in the expense allocation arena, for example, disclosure expands by multiples for managers to get comfortable that they've achieved effective disclosure. I'm not sure where the balance is. I think that standardization would be difficult.

HFLR: What are the most urgent issues facing regulators and funds on the cybersecurity front?

Van Grover: I think that's an especially difficult area among lawyers and compliance officers because it's very tech- and information technology- (IT) driven. In this area, when you attempt to build a procedure that you're going to be able to understand and follow, you need assistance from outside vendors or in-house IT people to formulate it and to carry it out. [See "*Cybersecurity and Outsourcing Remain Key and Potentially Costly Operational Issues for Hedge Fund Managers*" (May 5, 2016).]

Poglinco: This is an issue that people didn't worry about three or four years ago, and today it is front and center as a priority of the SEC and investment managers. Clearly, registered advisers have to respond. We've had guidance from the SEC in a number of interpretive guidance publications addressed to the industry. From a regulatory standpoint and also from a business standpoint, clients of advisers want assurances that firms have taken cybersecurity measures. You've got a regulatory focus, as well as a business or client relations focus. You have to think about the cybersecurity measures that key service providers to the adviser have taken.

HFLR: Do you see the enforcement and examination staff as having grown significantly more sophisticated in the way they identify and pursue matters?

Poglinco: The days of thinking you have sleeping exam staff coming in to look at a few documents are over. The SEC has significant expertise in the private fund industry, and we've seen really well-qualified and well-prepared

examiners uncover issues and really delve into them. It's just a different environment from what the industry has experienced before.

I think that the data and quantitative analysis that OCIE now uses has really improved its ability to deal with large amounts of trading information. In the past, it would have taken the SEC a long time to cull through information, but that's not the case now that OCIE has sophisticated technological tools to detect problems and analyze big sets of data. They have the expertise to delve into that kind of information. The SEC really can look for a needle in a haystack.

Van Grover: I agree. I'd say that use of the National Exam Analytics Tool (NEAT) program and similar analytics have changed the game. NEAT was originally developed by the SEC's Quantitative Analytics Unit in its National Exam Program. It allows them to see all sorts of patterns that previously would have been time-consuming and difficult to detect. Now, instead of taking very small periods of time and looking for patterns, they look for patterns over much larger periods, finding things that would have been near impossible to identify before. They look for patterns on insider trading, so if you were trading before a specific event, that can often be detected, in addition to other irregularities in your trading patterns.

Poglinco: The SEC can also identify patterns suggesting there might have been some manipulation of the market. They're staffed up, and their exam staff has extensive experience after examining the private fund industry for a number of years. They have experience with different types of trading strategies, and they don't hesitate to use outside experts on exam teams when they have a particular trading strategy. Sometimes we see examination staff teamed up with enforcement staff in the exam setting. Again, that's something that is always concerning, although I believe to some degree they do it for training and educational purposes.

It is important to be as prepared as you can be. I think one of the most important things is to monitor what the SEC is actually doing and saying, because that's all publicly available information. Make sure you are on

top of understanding what the SEC's examination priorities are and keep abreast of enforcement activity, because we learn a lot of from enforcement actions. Both OCIE and the Division of Investment Management put out guidance on various topics, and that's the SEC telling us what their views are. It is important to pay attention to those types of things.

Advisers can also prepare in other ways. We have clients who go through exam preparatory exercises on a regular basis by taking an exam request letter and simulating the request process to ensure they can put their hands on the information. There's also a lot of value in making sure that people likely to be interviewed by the SEC are properly prepared and understand what an SEC interview in an exam setting is like. Sometimes you have personnel who have never been in that setting, and we have clients who find this training and preparation to be a very valuable exercise.

Van Grover: One of the other things we advise is that, to the extent you can, you should monitor the speeches of key people at the SEC. That is often a bellwether of what is to come. Everyone is familiar with Julie Riewe's "*Conflicts, Conflicts Everywhere*" speech. Right after that speech, we were barraged with exams and enforcement actions that were focused around conflicts. [See "*Conflicts Remain an Overarching Concern for the SEC's Asset Management Unit*" (Mar. 12, 2015).]

Poglinco: We've seen a similar trend in the area of expense allocations. Although the SEC's activity has been in the private equity arena, we've seen a focus on this issue in the hedge fund examination setting. That topic was aired in an SEC speech, and we're still seeing that trend playing out.

With a topic like that – where there have been speeches, significant enforcement actions and enough time elapsed – registered advisers definitely should be monitoring their practices in that area in the event the SEC comes in for an examination.

HFLR: Should funds take steps to adjust their internal policies and procedures?

Poglinco: You want to have an expense allocation policy, and you should definitely look at your practices to see if there are any anomalies. An adviser gets some time to prepare, but once that has passed, the exam staff expects the adviser to be aware of those issues and to have taken whatever steps are appropriate for the business. It's good if you can demonstrate that attentiveness and responsiveness.

Van Grover: When you see some action and guidance at the regulatory level, you should show that you've adjusted your procedures accordingly. Then when people ask, "Why did you make that change?" the answer will be that you've adjusted accordingly in light of the heightened attention that the SEC has given this issue. I think that shows a culture of compliance – that your compliance program is living, breathing, evolving and improving. When the SEC addresses an issue, you address it.

Poglinco: People need to understand what the dynamic is going to be – that this is your primary regulator and they have a right to ask you for just about anything. You're obligated to provide it to examination staff. You need to respect the process, be thoughtful about what's going on and prepare your personnel. It's absolutely a big disruption when it happens, and the more prepared you are, the better it will go.

The firm has to be prepared by having all the documentation the SEC routinely asks for. You can prepare by obtaining a copy of the typical request letter and going through the motions by looking at your compliance program, what you're required to maintain as a registered adviser and what additional materials you maintain as part of your program. You need to make sure it's all accessible on a timely basis, which can be a big undertaking depending on the complexity of your business. More fundamentally, you need to make sure personnel in various areas of the firm understand their obligations and are able to demonstrate that understanding.

Your compliance program probably affects every part of the firm, and different people have different obligations – it's not just the chief compliance officer who is responsible for everything. The way people prepare is through training and a strong culture of compliance. It's communicated from the top of the firm that compliance is an important part of everything that's done at the firm. So, senior management participate in compliance training and programs. That's a message that people get, and to be able to demonstrate that to the SEC is very powerful. It shows that you understand what your obligations are. The firm values compliance.

Although some of this is very ephemeral, it is what the SEC looks for, and they've been clear about looking for it when they go into a firm.