



Legal Risk Management Tip
January 2012

PRIVATE FUND REGULATION: SEC EXAMINATION AND ENFORCEMENT HOT TOPICS – PART 2

As discussed in last month's legal tip, the March 30, 2012 deadline for previously unregistered advisers to hedge funds and other private funds to register with the Securities and Exchange Commission ("SEC") is rapidly approaching. With the SEC continuing to show signs of its intentions to scrutinize the activities of advisers to private funds, firms should take note of some of the areas that the SEC's Division of Enforcement and the Office of Compliance Inspections and Examinations ("OCIE") will pay particularly close attention to with regard to private fund advisers. These include, among other areas: (1) Performance; (2) Valuation; (3) Conflicts of Interest; (4) Insider Trading; and (5) Compliance Programs.

This legal tip is part two of a two-part series on private fund examination and enforcement hot topics. In part one, we discussed the SEC's focus on performance and valuation. This second installment will cover the topics of conflicts of interest, insider trading, and compliance programs.

Conflicts of Interest

The investment management industry is subject to a number of risks and conflicts of interest, some of which are common among all firms, and some of which are unique to each firm's organizational structure, advisory products and services, business relationships, and other attributes. The SEC is paying particularly close attention to a variety of conflicts of interest affecting advisers to private funds. Examination staff will expect firms to have in place customized and detailed processes for identifying, evaluating, and addressing the specific conflicts of interest applicable to each firm's business.¹ Specifically, regulators will be focusing on the adequacy of disclosures to investors about financial industry affiliations, soft dollars, personal trading and co-investment practices, conflicting investment strategies, trade allocation practices between multiple funds or between a fund and separate accounts, and the use of side letters or other preferential treatment of certain investors.²

Side-by-side management of a private fund and separate accounts is a major concern for the SEC, due to the fact that managers have an incentive to give preferential treatment to the fund,

¹ See The Evolving Compliance Environment: Examination Focus Areas, 2009 CCO Outreach Regional Seminars (Apr. 2009) <http://www.sec.gov/info/iaiccco/iaiccco-focusareas.pdf>.

² Carlo V. di Florio, Director, Office of Compliance Inspections and Examinations U.S. Securities and Exchange Commission, Remarks at the IA Watch Annual IA Compliance Best Practices Seminar (Mar. 21, 2011), available at <http://www.sec.gov/news/speech/2011/spch032111cvd.htm>; see also, Carlo V. di Florio, Director, Office of Compliance Inspections and Examinations U.S. Securities and Exchange Commission, Speech by SEC Staff: Private Equity International's Private Fund Compliance *May 3, 2011) available at <http://www.sec.gov/news/speech/2011/spch050311cvd.htm>.

which pays performance fees, as opposed to accounts paying only asset-based fees.³ As fiduciaries, advisers are expected to act in the best interest of all clients, which requires firms that engage in side-by-side management to have policies and procedures in place that ensure that certain accounts are not favored over others. For example, firms may implement allocation procedures based on a rotational basis in which allocations are made based upon a pre-established order or through the use of an automated system that allocates trades randomly among all accounts to ensure that hedge funds are not favored over separate account clients. In situations where trades may be allocated differently from the firm's general allocation policies, firms may require a written justification and/or compliance approval to ensure fair and equitable treatment of all accounts.⁴ In all cases, firms should be sure to clearly and accurately disclose their allocation practices as well as the existence of the associated conflicts of interest in Form ADV Part 2A and explain how the firm addresses and mitigates such conflicts.⁵

Firms can expect SEC staff to inquire about the use and terms of side letters or other preferential treatment provided to certain investors but not others.⁶ The SEC is concerned about the inherent conflicts of interest presented when different investors in a fund have different rights, such as "most favored nation" clauses,⁷ preferential redemption rights, greater access to information about the fund or the strategy and dissimilar fee structures.⁸ The authority to enter into side letters should be set forth in the fund's governing documents, and disclosure about the risks and conflicts of such arrangement should be thoroughly described in the private placement memorandum. Adherence to the specific terms of each side letter should be continuously and carefully monitored to ensure no additional preferences are given beyond what is contemplated in the side letter and the disclosures made in the offering documents. In addition, firms should keep a file of all side letters since SEC staff will likely request copies during an examination.

Accordingly, in anticipation of private fund advisers coming under the regulatory jurisdiction of the SEC, firms should be sure to identify actual and potential conflicts, adopt procedures to address or mitigate against them, and make full and fair disclosure of the relevant conflicts to existing and prospective investors.

³ Lori A. Richards, Then Acting Director, Office of Compliance Inspections and Examinations, Securities and Exchange Commission, Speech by SEC Staff: The Need for More Proactive Risk Assessment at NRS Annual Spring Compliance Conference (Apr. 14, 2004) <http://www.sec.gov/news/speech/spch041404lar.htm>.

⁴ See SMC Capital, Inc., SEC No-Action Letter (Sept. 5, 1995), available at <http://www.sec.gov/divisions/investment/noaction/1995/smccapital090595.pdf>.

⁵ *Id.*; Richards, *supra* note 3.

⁶ Carlo V. di Florio, Director, Office of Compliance Inspections and Examinations U.S. Securities and Exchange Commission, Speech by SEC Staff: Private Equity International's Private Fund Compliance (May 3, 2011), available at <http://www.sec.gov/news/speech/2011/spch050311cvd.htm>.

⁷ Some side letters automatically grant an investor the most favorable terms granted to other investors. For example, if any other investor in the fund receives a lower fee for similar investments, the side letter would give the investor the right to lower the fee.

⁸ Lori A. Richards, Former Acting Director, Office of Compliance Inspections and Examinations, Securities and Exchange Commission, The Need for More Proactive Risk Assessment at NRS Annual Spring Compliance Conference (Apr. 14, 2004), available at <http://www.sec.gov/news/speech/spch041404lar.htm>.

Insider Trading

Insider trading has been a top priority for the SEC for some time, and the scrutiny paid to this area has dramatically increased over the past two years.⁹ Moreover, the SEC recognizes that many hedge funds are in a unique position to obtain and potentially act on material nonpublic information, and the SEC has responded by increasing the number of insider trading cases involving hedge funds.¹⁰ In order to combat hedge fund insider trading, the Enforcement Division created a new Market Abuse Unit tasked with identifying and taking action against various abusive market practices, including complex insider trading schemes involving hedge funds.¹¹ SEC examination staff will carefully scrutinize whether firms have implemented procedures to identify the source and type of nonpublic information, whether firms have established guidelines and controls to prevent the misuse of such information, and whether those procedures are periodically tested and updated.¹² Of particular concern to examination staff with regard to hedge funds is where certain investors in a hedge fund are officers or directors of a public company, and may be providing the manager or its personnel with inside information obtained from their positions with the companies.

Accordingly, firms should review and if necessary, revise their insider trading policies and procedures to ensure that the sources of all information is documented and that internal controls are in place to identify, contain, and prevent the unauthorized or inappropriate use of any material nonpublic information that comes into the possession of the adviser or its employees. Where an employee comes into possession of material, nonpublic information, the information should be promptly identified, documented, and contained in order to ensure it is not misused. Senior management should regularly examine proprietary and personal trading activity and investigate any unusual activity detected. Firm personnel also should be educated and trained on identifying and handling any nonpublic information that they may come across. Finally, where it is unclear whether information obtained is material or nonpublic, compliance or legal staff should be consulted immediately for further review.

Compliance Programs

The new registration requirements will subject private fund advisers to Rule 206(4)-7 of the Investment Advisers Act, also known as the “Compliance Program Rule,” which requires SEC registered investment advisers to: (1) adopt and implement written policies and procedures that are reasonably designed to prevent, detect, and correct securities law violations; (2) designate a

⁹ *Hearing on Insider Trading and Congressional Accountability Before the S. Comm. on Homeland Security and Governmental Affairs*, 112th Cong. (2011) (statement of Robert Khuzami, Director, Division of Enforcement, U.S. Securities and Exchange Commission), available at <http://www.sec.gov/news/testimony/2011/ts120111rsk.htm> [hereinafter *Insider Trading Hearing*].

¹⁰ Luis Aguilar, Commissioner, U.S. Sec. & Exch. Comm’n, *Hedge Fund Regulation on the Horizon—Don’t Shoot the Messenger* (June 18, 2009); see also SEC Enforcement Actions—Insider Trading Cases, <http://www.sec.gov/spotlight/insidertrading/cases.shtml> (last visited Dec. 12, 2011).

¹¹ *Insider Trading Hearing*, *supra* note 9.

¹² Lori A. Richards, Former Acting Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, *Focus Areas in SEC Examinations of Investment Advisers: the Top 10 by IA Compliance Best Practices Summit 2008*, (Mar. 20, 2008), available at <http://www.sec.gov/news/speech/2008/spch032008lar.htm>.

Chief Compliance Officer (“CCO”) to administer the compliance program; and (3) annually review the effectiveness of the firm’s compliance policies and procedures. As noted by Robert Kaplan, Co-Chief of the SEC Division of Enforcement’s Asset Management Unit, “[t]he failure to adopt and maintain adequate compliance policies and procedures is a significant violation of the federal securities laws,”¹³ and the SEC views failure to adopt and maintain effective compliance programs and grounds for an enforcement action.

Consequently, advisers to private funds will need to dedicate significant time and resources to developing and enhancing their compliance programs, and in the current regulatory environment, compliance must be treated as an important, necessary operation within the organization. Policies and procedures should be adopted that take into consideration the nature of each firm's operations and business activities. In designing policies and procedures, firms should identify the unique risks and conflicts of interest that apply to their advisory business and design procedures that address those risks.¹⁴ The designated CCO should be competent and knowledgeable and should be given the appropriate authority with the firm in order to administer and enforce the compliance program.

Conclusion

As s noted in last month’s legal tip, the March 30, 2012 registration deadline for previously unregistered private fund advisers is looming. The SEC expects compliance programs to be fully established and implemented by the time firms are registered, so firms should not delay the establishment of the required policies and procedures. Developing a strong compliance program will enable private fund advisers to be sufficiently prepared for the SEC’s increased scrutiny of the private fund industry. Be sure to identify, disclose and address all actual and potential conflicts, establish internal controls for the handling of material non-public information, and establish customized compliance policies and procedures that are designed to prevent violations of securities laws. As always, feel free to contact us at info@jackolg.com with any additional questions.

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This article is for information purposes and does not contain or convey legal advice. The information herein should not be relied upon in regard to any particular facts or circumstances without first consulting with a lawyer.

¹³ Press Release, Sec. & Exch. Comm’n, SEC Penalizes Investment Advisers for Compliance Failures (Nov. 28, 2011) available at <http://www.sec.gov/news/press/2011/2011-248.htm>.

¹⁴ Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2204, Investment Company Act Release No. 26299, 68 Fed. Reg. 74714 (Dec. 24, 2003), available at <http://sec.gov/rules/final/ia-2204.pdf>.