



Legal Risk Management Tip December 2011

PRIVATE FUND REGULATION: SEC EXAMINATION AND ENFORCEMENT HOT TOPICS – PART 1

As 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”) rapidly approaches, the SEC is continuing to show signs of its intentions to scrutinize the activities of advisers to private funds. As noted by Robert Khuzami, the Director of the SEC’s Enforcement Division, the SEC is “committed to pulling back the curtain on hedge fund operations and taking a closer look at their activity.”¹ As part of the recent re-organization of the Division of Enforcement, the SEC has created a number of new specialized units, several of which will focus primarily on the activities of private fund advisers. In addition, the Office of Compliance Inspections and Examinations (“OCIE”), which is responsible for administering examinations and inspections of SEC-registered entities, has indicated that examinations of private fund advisers will be a priority. As the staffs of the Enforcement Division and OCIE each increase the scrutiny paid to the private fund industry, the SEC has taken steps to ensure better collaboration between examination and enforcement personnel, which means that deficiencies noted by examiners, if not adequately addressed, are likely to lead to an enforcement action.²

In anticipation of these developments, firms should take note of some of the areas that the SEC has indicated that it will pay particularly close attention to with regard to the activities of private fund advisers. These include, among other areas: (1) Performance; (2) Valuation; (3) Conflicts of Interest; (4) Insider Trading; and (5) Compliance Programs.

This will be a two-part series. In this first month’s legal tip, we will focus on performance and valuation.

Performance

As part of an initiative to identify fraudulent activity involving hedge funds, the Enforcement Division’s Asset Management Unit (one of several new specialized units created as part of a recent reorganization of the SEC Division of Enforcement), has launched the Aberrational Performance Inquiry, an initiative aimed at scrutinizing performance that the SEC deems “too good to be true.”³ Using proprietary risk analytics and other methods to evaluate hedge fund returns, the SEC intends to closely monitor hedge funds that consistently generate above-market returns, particularly where the performance appears to be inconsistent with the fund’s stated investment strategy.⁴ During a recent congressional testimony, Enforcement Director Khuzami stated that the SEC is “canvassing all hedge funds for aberrational performance,” focusing on “anybody who is beating market indexes by 3 percent and doing it on a steady basis.”⁵

In light of the fact that a successful track record will draw attention from the SEC, fund advisers should carefully review all performance calculations prior to disseminating to existing and potential investors. As a best practice, advisers should consider using an independent third party to verify performance claims. Moreover, as noted

¹ Robert Khuzami, Director, Div. of Enforcement, U.S. Sec. & Exch. Comm’n, Remarks at Press Conference at U.S. Attorney’s Office for the Southern District of New York (Oct. 16, 2009), *available at* <http://www.sec.gov/news/speech/2009/spch101609rk.htm>.

² *See, e.g.*, Press Release, Sec. & Exch. Comm’n, SEC Penalizes Investment Advisers for Compliance Failures (Nov. 28, 2011), *available at* <http://sec.gov/news/press/2011/2011-248.htm>.

³ Press Release, Sec. & Exch. Comm’n, SEC Charges Multiple Hedge Fund Managers with Fraud in Inquiry Targeting Suspicious Investment Returns (Dec. 1, 2011), *available at* <http://www.sec.gov/news/press/2011/2011-252.htm>.

⁴ *Id.*

⁵ *Oversight of the Securities and Exchange Commission’s Operations, Activities, Challenges and FY 2012 Budget Request: Hearing Before the Subcomm. on Capital Markets and Government Sponsored Enterprises of the H. Comm. on Fin. Servs.*, 112th Cong. 32 (2011) (statement of Robert Khuzami, Director, Division of Enforcement, U.S. Securities & Exchange Commission), *available at* <http://financialservices.house.gov/UploadedFiles/112-14.pdf>.

above, as part of the Aberrational Performance Inquiry, the SEC will compare a fund's performance results to the investment strategy disclosed to investors, and any inconsistencies will lead to increased scrutiny. Even if the result is favorable to investors, where an adviser makes investments that are outside the scope of the stated investment program (referred to as "style drift"), the SEC may determine that the adviser has breached its duties to the fund and the investors. Accordingly, firms should consider implementing policies and procedures to closely monitor the investment activities of their funds to ensure that the investments made are consistent with the disclosures provided to investors. In the event that changes to a fund's stated investment strategy are necessary due to changing market conditions, or where an adviser determines to pursue investment opportunities beyond that which has disclosed to investors, firms should prepare and distribute amendments or supplements to offering documents in order to ensure full and fair disclosure.⁶

Valuation

The SEC views the valuation and pricing policies of advisers to private funds as a critical issue and a source of significant potential conflicts of interest. This is in large part because an adviser's management and performance fees are based on the net asset value of the fund, providing a strong incentive to over-value investment positions. In addition, many hedge funds own thinly traded securities and derivatives whose valuation can be very complicated, which provides the opportunity to improperly overvalue investment positions. A common theme among recent SEC enforcement actions involving hedge funds relates to overstating net asset value in order to hide losses or to artificially boost performance.⁷ Fraudulently inflated valuations also enable funds to attract new investors, deter redemptions, and increase management and performance fees. The SEC is therefore paying close attention to the valuation practices of private fund advisers, and examination staff will expect to see detailed pricing and valuation policies and procedures that are customized to the types of investments made by the fund, especially investments that are illiquid or difficult to value. The presence of sufficient internal controls over the valuation process is, in the SEC's view, critical to minimizing potential conflicts of interest.

Given the intense scrutiny expected with regard to valuation, firms should ensure that valuation practices are clearly and accurately disclosed to investors, and that internal controls over the valuation process are consistently applied and monitored to ensure that conflicts of interest are avoided or minimized. Conducting initial and ongoing due diligence into the policies, practices, and controls of any independent pricing services used to value fund investments should be conducted in order to ensure the consistency of the methodology used and the accuracy of the valuations provided. Periodically comparing internal valuations to those of third parties can help firms identify and address any pricing inaccuracies. Finally, to the extent practicable, segregation of duties between portfolio management and valuation personnel or the use of an independent valuation committee can help avoid potential conflicts of interest relating to the valuation of investment positions.

Side-Pockets:

A common feature of many hedge funds is the use of "side pockets" to hold certain illiquid or difficult-to-value assets, thereby segregating the assets in the side pocket from the remainder of the portfolio. Side pocket investments are valued separately from other assets and the manager generally does not receive a performance fee for assets held in a side pocket until they are sold or removed from the side pocket. Properly employed, side pockets offer operational advantages to the manager and also serve to benefit investors since side pockets essentially insulate the fund's general portfolio from the performance of certain illiquid portfolio holdings until market conditions improve and they can be sold. Despite the various advantages side pockets can provide, side pocket arrangements may be abused, and the SEC is therefore closely scrutinizing the use and implementation of side pockets by hedge funds. Specifically, the SEC is concerned that hedge fund managers may use side pockets

⁶ See BEST PRACTICES FOR THE HEDGE FUND INDUSTRY, REPORT OF THE ASSET MANAGERS' COMMITTEE TO THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS at 2 (Jan. 15, 2009), available at <http://www.amaicmte.org/Public/AMC%20Report%20-%20Final.pdf>.

⁷ *The Role of Hedge Funds in Our Capital Markets: Hearing Before the Subcomm. on Securities and Investment of the S. Committee on Banking, Housing, and Urban Affairs*, 109th Cong. 59 (2006) (statement of Susan Ferris Wyderko, Acting Director, Office of Investor Education and Assistance, U.S. Securities & Exchange Commission), available at <http://www.gpo.gov/fdsys/pkg/CHRG-109shrg48525/pdf/CHRG-109shrg48525.pdf>.

to hide poorly-performing assets from valuation to increase management and performance fees, misappropriate fund assets, or otherwise shield their activities from investors.

SEC examination staff will be carefully reviewing side pocket arrangements of advisers to hedge funds, particularly whether the valuations applied to side-pocketed investments are consistent with the adviser's pricing policies and procedures.⁸ In addition, the Asset Management Unit of the Enforcement Division is actively investigating the use and implementation of side pockets, specifically whether side pockets are authorized by the governing documents of the fund, whether the offering documents contain adequate disclosures about the use and risks of side pockets, and whether side pockets are employed for legitimate purposes and pursuant to a consistently applied methodology.⁹

Accordingly, hedge fund managers should review any existing side pocket arrangements and disclosures that have been made to investors to ensure that the amount and types of investments placed in side-pockets are consistent with the information set forth in offering documents. The methodology for valuing side pocket investments and the criteria for determining what assets may be side-pocketed should be clearly and consistently applied. Each fund's limited partnership agreement or other governing document should authorize the use of side pockets and private placement memoranda (or similar offering documents) should disclose whether side pockets may be used, what types of assets may be placed in a side pocket, any restrictions or limitations on the use of side pockets or the amount of assets that may be placed in a side pocket, the procedures for valuing side pocket investments, and the risks associated with using a side pocket. More generally, firms should establish and consistently apply written valuation procedures, including the use of independent valuation services, and compare and reconcile internal valuations with those received from outside sources.

Conclusion

For previously unregistered advisers to private funds, the March 30, 2012 registration deadline is looming. Given the increase focus by the SEC on private funds, advisers should carefully review their practices, policies, procedures and internal controls in every aspect of their business. The SEC will expect compliance programs to be fully established and implemented by the time firms are registered, so it is important not to delay the establishment of the required policies and procedures until after becoming registered. In the immortal words of Lori A. Richards, former Director of the SEC's examination program, "[i]t's *not* enough to have good intentions . . . compliance must be an embedded part of your firm's culture."¹⁰ The SEC expects firms to demonstrate a "culture of compliance" from the top down, and 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 evaluate your performance and valuation internal controls and contact us at info@jackolg.com with any additional questions. Happy holidays!

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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.

⁸ 2009 CCO Outreach Regional Seminar, *The Evolving Compliance Environment: Examination Focus Areas*, at 7 (Apr. 2009), available at <http://www.sec.gov/info/iaiccco/iaiccco-focusareas.pdf>.

⁹ See Jenny Strasburg, *SEC Probes 'Side Pocket' Arrangements*, WALL ST. J., Apr. 28, 2010, available at <http://www.efinancialnews.com/story/2010-04-28/sec-probes-hedge-fund-managers>; see also Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Georgia-Based Hedge Fund Managers With Fraud in Valuing a "Side Pocket" and Theft of Investor Assets (Oct. 19, 2010), available at <http://www.sec.gov/news/press/2010/2010-199.htm>; Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Bay Area Hedge Fund Manager With Misappropriating "Side Pocketed" Assets (Mar. 1, 2011), available at <http://www.sec.gov/news/press/2011/2011-54.htm>.

¹⁰ Lori A. Richards, Former Director, Office of Compliance Inspections and Examinations, Securities and Exchange Commission, *The Culture of Compliance at Spring Compliance Conference: National Regulatory Services* (Apr. 23, 2003), available at <http://www.sec.gov/news/speech/spch042303lar.htm>.