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Private Fund Regulation: SEC Examination and Enforcement Hot Topics

by Zachary Rosenberg

As the March 30, 2012 deadline for previously unregistered advisers to hedge funds and other private funds to register with the SEC rapidly approaches, the Commission 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.

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 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

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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 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.

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.[10] Specifically, regulators will be focusing on the adequacy of disclosures to investors about financial industry affiliations, the use of soft dollars, personal trading, the use of side letters or other preferential treatment of certain investors, trade allocation practices between multiple funds or between a private fund and any separate accounts managed by the adviser.

The SEC has also been particularly

vocal about its intention to scrutinize conflicts of interest relating to private equity funds, a segment of the industry that the SEC has expressed an interest in for some time.[11] Areas of particular interest to regulators involving private equity funds are co-investment practices, preferential terms to certain investors, conflicting investment strategies, and allocation practices, among others.[12] Accordingly, with advisers to private equity funds and other private funds 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.

Side-by-Side Management:

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, which pays performance fees, as a opposed to accounts paying only asset-based fees.[13] As fiduciaries, advisers are expected to act in the best interest of all clients, which would require 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 want to require compliance approval prior to purchasing or selling a security for the hedge fund that could also be purchased for separate account clients. Prohibiting certain investments by hedge funds that could adversely affect other clients could also help minimize the effect of these conflicts. In all cases, firms should be sure to clearly and accurately disclose the existence of this conflict in Form ADV Part 2A and how the firm addresses it.[14]

Side Letters:

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.[15] 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,[16] preferential redemption rights, greater access to information about the fund or the strategy, or different fee structures.[17] Thorough disclosure of these arrangements is the key to avoiding SEC violation. 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 examination staff will likely request copies and will expect firms to have internal controls for ensuring that side letter arrangements are authorized and adhered to in practice.

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.[18] 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.[19] Due to the large trading volumes, well-placed contacts, and sophisticated trading strategies, the hedge fund industry holds a more dominant role in the market than ever before.[20] 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, many of which have previously gone undetected using traditional surveillance techniques.[21] Most recently, the SEC's investigation of Galleon hedge fund manager Raj Rajaratnam resulted in record civil penalties against Rajaratnam personally as well as criminal convictions of Rajaratnam and various other hedge fund managers and corporate executives involved in the insider trading scheme.[22]

The recent enforcement actions have already affected the industry, at least psychologically. Fund managers are now more sensitive in deciding whether information obtained is appropriate to use. Firms should review their insider trading policies and procedures to ensure that the sources of all information is documented and that internal controls are in place to ensure that any material nonpublic information is identified and not acted upon. SEC examination staff will carefully scrutinize the effectiveness of controls to prevent insider trading and will particularly focus on 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.[23] 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, advisers should review and if necessary, revise their insider trading procedures to ensure that they contain effective processes to identify, contain, and prevent the unauthorized or inappropriate use of 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

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misused. Senior management should regularly examine trading activity and follow up on any unusual activity, and staff should be educated and trained on identifying and handling any nonpublic information. Finally, where it is unclear whether information obtained is material, nonpublic information, compliance or legal staff should be consulted before disclosing or acting on the information.

Compliance Programs

In addition to the particular areas of interest discussed above, the SEC is focusing on compliance practices generally, particularly the role of the Chief Compliance Officer ("CCO"). Under Rule 206(4)-7 of the Investment Advisers Act, also known as the "Compliance Program Rule," registered investment advisers are required to adopt and implement written policies and procedures that are reasonably designed to prevent, detect, and correct securities law violations.[24] Until recently, many private fund advisers were able to avoid SEC registration, but Dodd-Frank and the rules adopted thereunder significantly changed the regulatory environment for private fund advisers, and the requirements of the Compliance Program Rule is are extremely important aspect of SEC registration. Recently, the SEC announced three enforcement actions against registered advisers for compliance failures, many of which will be areas of focus when the SEC begins examinations of previously unregistered private fund advisers.[25] 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,"[26] and the SEC views failure to adopt and maintain effective compliance programs as grounds for an enforcement action. Some of the deficiencies cited by the SEC that are particularly applicable to private funds are failure to: institute a compliance program, establish and enforce a written code of ethics, review financial reports, evaluate transactions to identify any prohibited practices, review at least annually written compliance policies, etc.[27]

The new registration requirements will subject private fund advisers to the Compliance Program Rule, which requires all advisers to implement customized compliance policies and procedures, designate a CCO to administer the compliance program, and annually review the effectiveness of the firm's compliance policies and procedures. Moreover, recent amendments to Parts 1 and 2 of Form ADV and the creation of Form PF have increased the amount of information about private funds available to the SEC for monitoring systemic risk and possibly as grounds for enforcement investigations. Such information includes amount and types of assets held, use of leverage, side letter arrangements, and credit risk exposure, among others. Since the SEC maintains a risk-based examination program, this information will be used as a guideline to identify particularly "risky" funds that may warrant an examination.

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 and 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.[28] 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

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."[29] 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.

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.

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.

8. 2009 CCOutreach 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, a*vailable 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. *See* The Evolving Compliance Environment: Examination Focus Areas, 2009 CCOutreach Regional Seminars (Apr. 2009) http://www.sec.gov/info/iaiccco/iaiccco-focusareas.pdf.

11. 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.

12. *Id.*; *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.

13. 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.

14. *Id*.

15. 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.

16. 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 a similar investments, the side letter would give the investor the right to lower the fee.

17. 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

18. *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*].

19. 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).

20. Robert Khuzami, Director, Division 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.

21. *Insider Trading Hearing*, *supra* note 18.

22. *Id.*; *see also* Press Release, Sec. & Exch. Comm'n, SEC Charges New York Hedge Fund and Wall Street Professionals in Galleon-Related Enforcement Action (Jan. 10, 2011), *available at* http://www.sec.gov/news/press/2011/2011-6.htm

23. 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.

24. 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.

25. *Id*.

26. *Id*.

27. Steve Quinlivan, *SEC Penalizes Investment Advisers for Compliance Failures—Lessons For Soon to be Registered Advisers to Private Equity and Hedge Funds,* Dodd-Frank.com, Nov. 28, 2011, http://dodd-frank.com/sec-penalizes-investment-advisers-for-compliance-failures%E2%80%94lessons-for-soon-to-be-registered-advisors-to-private-equity-and-hedge-funds/.

28. 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) http://sec.gov/rules/final/ia-2204.pdf.

29. 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.

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