

Recent Areas of Focus in SEC Examinations of Hedge Fund Advisers

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I. Introduction

Hedge fund advisers continue to be a significant priority for the Securities and Exchange Commission (the “SEC” or the “Commission”) in its rulemaking, enforcement, and examination efforts. The SEC’s response to the financial crisis and severe market declines of 2008 was to adopt unprecedented restrictions on short selling, including an “Interim Final Temporary Rule” that required hedge fund advisers to disclose certain short sales and positions on a weekly basis.² Although the Interim Final Temporary Rule recently was permitted to lapse, the SEC announced it will be considering additional short sale disclosures and also will be working with self-regulatory organizations to “substantially increase the public availability of short sale-related information” including publication of daily short sale volumes of individual equity securities.³ The SEC also recently proposed reinstatement of some version of an “uptick rule” to limit short selling in a down market.⁴ While changes in short sale rules are of general application, it is clear from statements, speeches and testimony that the short selling activities of hedge funds were a motivating concern of the SEC and the regulators around the world who imposed restrictions on short selling.⁵

The SEC has brought more enforcement actions against hedge funds than ever before,⁶ and as of late April 2009 said it had 150 hedge fund investigations ongoing.⁷ The SEC’s “focus on hedge funds” also is reflected in the formation of a “Hedge Fund Working Group” in 2006 within the SEC’s Enforcement Division,⁸ and the expansion of that group in 2007 to include the SEC’s home office in Washington, D.C. and all regional offices. The Hedge Fund Working Group works closely with examiners from the SEC’s Office of Compliance Inspections and Examinations (“OCIE”) to identify important issues to investigate.⁹ More recently, the SEC’s new Director of the Division of Enforcement announced the creation of an Asset Management Unit focusing on investment

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advisers, investment companies, hedge funds and private equity funds, which will work closely with OCIE to address issues including disclosures, valuations, performance reporting, due diligence and diversification, transactions with affiliates, misappropriation and conflicts of interest.¹⁰

In recent months four significant pieces of legislation have been proposed in Congress to register and regulate hedge fund advisers. A proposal by the Treasury Department entitled the Private Fund Investment Advisers Registration Act of 2009 would require all hedge fund advisers who manage above a *de minimis* amount of assets to register as investment advisers with the SEC.¹¹ Such a requirement would bring hundreds, if not thousands, of new advisers under the SEC's examination authority. OCIE was able to examine only approximately 14% of registered investment advisers in 2008,¹² and it is anticipated that the SEC will examine only 9% of registered investment advisers in 2009 and 2010.¹³ With a flood of new advisers to become registered within the next year, OCIE faces a daunting task. The failure of the examination program to detect several high-profile investment adviser frauds – including the Ponzi scheme perpetrated at Bernard Madoff's investment adviser – has led to Congressional criticism of the SEC¹⁴ and the forthcoming reports of the SEC's Inspector General which undoubtedly will reopen this issue.¹⁵

The purpose of this article is to identify and discuss recent areas of focus in SEC examinations of hedge fund advisers and recommend possible steps hedge fund advisers can take to prepare for and manage an SEC examination. Four areas that OCIE has indicated it will focus on when examining hedge fund advisers are:

- the possibility of preferential treatment in redemptions;
- side pocket arrangements;
- insider trading; and
- activities outside of disclosed strategies.¹⁶

The article also briefly touches on a number of other issues SEC examiners are addressing during examinations of hedge fund advisers:

- custody and controls over investor assets;
- controls over valuation;
- supervision and compliance;
- revenue sharing; and
- performance reporting.¹⁷

II. OCIE Highlights Four Compliance Issues

A. Possibility of preferential treatment in redemptions

During the past year hedge funds were doubly affected by the extraordinary lack of liquidity in certain financial markets. First, many funds' investments rapidly turned from liquid to illiquid, changing the nature of the portfolios and making the investments difficult if not impossible to sell at anything other than "fire sale" prices. Second, investors facing the lack of liquidity in the financial markets sought liquidity from hedge funds in unprecedented numbers. This double bind led many hedge fund managers to impose gates, restricting the amount of cash that could come out of a fund. Other managers suspended redemptions so that all of the liquidity in the funds would not be used to pay redeeming investors, leaving the non-redeeming investors with an entirely illiquid portfolio.

The funds' governing documents typically set forth the ability to suspend redemptions, put up a gate to limit redemptions on an aggregate or investor-by-investor basis, or make distributions "in-kind" instead of cash. SEC examiners have looked at whether any suspension of redemptions or use of a gate was for a proper purpose -- i.e., a purpose set forth in the fund's governing documents and disclosed to investors. Of paramount importance to the SEC has been whether certain investors were permitted to redeem their investments despite a suspension of redemptions, or on other preferential terms.

SEC Commissioner Elisse Walter made it clear that the SEC is concerned about the liquidity of pooled investment vehicles and the procedures for redemption.¹⁸ In her testimony before the House Committee on Financial Services, the Commissioner indicated the SEC will be particularly focused on whether advisers favored their own interests above others and whether principals, employees or other investors favored by the hedge fund adviser may have received preferential redemptions from the fund.¹⁹ Preferential treatment could take a variety of forms, including permitting only certain investors to redeem:

- Without requiring the typical notice period;
- Regardless of a lock-up; or

- When redemptions are otherwise gated or suspended, or just preceding the imposition of a gate or suspension.

Preferential redemption also could occur if a manager provides some investors with distributions in cash and others receive distributions in kind.

Examinations with respect to preferential redemptions may be particularly challenging because the SEC Staff is still developing experience and familiarity with the issue. Advisers should be prepared to walk the Staff through the relevant provisions in the governing documents, provide records showing subscriptions and redemptions, and explain any aspects of the redemptions that the Staff could consider preferential to certain investors. The adviser's records showing subscriptions and redemptions and the impact of gating and suspensions on each investor may not all be kept in one place (e.g., some may be at the administrator) and may not be easy to follow in the first instance.

SEC examiners also often review any side letters the manager may have with investors.²⁰ The Staff typically evaluates whether the terms and conditions of side letters are consistent with the adviser's disclosures to investors. In the context of restrictions on redemptions, the Staff also has focused on whether side letters give certain investors preferential liquidity that could negatively affect other investors.

Because of the imposition of gates and suspensions of redemptions by many funds, certain investors have expressed increased interest in investing through separately managed accounts. In situations in which managed accounts invest *pari passu* with a pooled vehicle and may be redeemed on short notice, SEC Staff members have also indicated they intend to consider whether the arrangement could be harmful to investors in the pooled vehicle because redemptions by the managed accounts reduce the liquidity available to the investors in the pooled vehicle.

B. Side Pocket Arrangements

Indications are that SEC examiners also may take a close look at side pocket arrangements.²¹ Side pockets authorized by a fund's governing documents can benefit investors by allowing the adviser to separate difficult-to-value investments from the

rest of a portfolio. Performance fees are calculated without including side-pocketed investments to avoid overpayment or underpayment of the adviser. Side pockets also are not used to satisfy redemption requests because they might not be sold at the optimal time.

The SEC Staff has indicated that it will look at whether the valuations applied to side-pocketed investments are consistent with the adviser's pricing policies and procedures.²²

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Examination staff often review fund governing documents and offering memoranda to determine whether side pockets are permitted, and whether there is adequate disclosure to investors regarding the possibility that certain investments could be side-pocketed, and the potential risks associated with side-pocketing. Because profits of a side-pocketed investment will be allocated only to investors who were investors in the fund when the investment was side-pocketed, potential investors should be made aware that they will not receive a share of the side-pocketed investment proceeds upon realization of the investment's returns. In addition, examination staff may consider whether the adviser adhered to any limitations on the percentage of a fund's assets that can be placed into side pockets.

The SEC also has examined whether investments were placed in a side pocket pursuant to legitimate and consistently applied criteria. For example, as noted by former SEC Commissioner Roel Campos, there is a risk that hedge fund advisers could hide poorly-performing assets in side pocket accounts to exclude such assets from a fund's valuation for purposes of calculating performance fees or to segregate poorly-performing assets so they can later be disposed of during a down period when the disposal will not impact any incentive fee.²³

C. Insider Trading

For some time, the SEC has been “targeting hedge fund insider trading as a top priority”²⁴ and Congress has expressed an interest in SEC insider trading actions against hedge fund managers.²⁵ As a result, the number of insider trading cases brought by the SEC involving hedge funds has increased and the SEC has indicated that enforcement of insider trading laws will continue to be a priority when it comes to hedge funds.²⁶

SEC’s new Director of the Division of Enforcement announced the creation of an Asset Management Unit focusing on investment advisers, investment companies, hedge funds and private equity funds, which will work closely with OCIE to address issues including disclosures, valuations, performance reporting, due diligence and diversification, transactions with affiliates, misappropriation and conflicts of interest.

According to Lori Richards, until recently the Director of OCIE, examiners will review controls in place to prevent insider trading in client, proprietary, or employee accounts.²⁷ Examiners will look at “information flows” – identifying where material non-public information may enter the firm, where it may move within the firm, and where it may go outside of the firm.²⁸ Advisers are expected to devise and implement policies that appropriately address the handling of material non-public information.²⁹ One particular source of material non-public information OCIE has focused on is hedge fund investors who are officers or directors of public companies. SEC Staff have expressed concern that these so-called “value-added investors” may be providing the fund’s personnel with inside information regarding the companies for which the investor serves as an officer or director.

Advisers should carefully review their efforts with respect to handling material non-public information and should expect that during examinations the SEC will ask:

- “Do you have effective processes to identify, contain, and prevent the unauthorized and/or inappropriate use of non-public information that comes into your possession?”;
- “If your employees come into possession of non-public information, is this information effectively identified, documented, and contained so that it is used appropriately?”; and
- “If your employees come into possession of non-public information about an issuer as a result of a client’s position in that issuer (e.g., a participation in a bank loan), is this information controlled effectively so that it is not used to unlawfully trade in other instruments of the issuer (e.g., shorting the issuer’s equity if the issuer’s financial condition deteriorates)?”³⁰

The SEC has identified several common deficiencies related to insider trading in its examinations of investment advisers. Advisers should consider whether any of these deficiencies identified below may apply to them:

- *Code of Ethics compliance was incomplete.* Under Rule 204A-1 (the “Code of Ethics” rule), registered advisers must require that access persons obtain pre-approval for limited investment opportunities such as private placements and initial public offerings.³¹
- *Code of Ethics was not followed.* Compliance with the Code of Ethics requires a significant amount of detailed recordkeeping (for example, advisers are typically required to receive duplicate trade confirmation statements from all access persons³²) and the SEC has often viewed the failure to comply with these requirements as a deficiency.³³ In addition, SEC examiners also have looked for weaknesses in an adviser’s control procedures regarding oversight of supervised investment personnel -- for example, situations where investment personnel disclosed sensitive portfolio and trading information to advisory personnel at other advisory firms.³⁴
- *Reporting requirements were not followed or monitoring was not performed.* SEC examiners have found deficiencies where access persons failed

to submit reports of their personal securities transactions, or submitted such reports late.³⁵ In addition, the SEC has focused on advisers failing to review reports for indications that trades were inconsistent with applicable regulations or the adviser's policies and procedures.³⁶

- *Disclosure was inadequate.* Deficiencies also have been found when an adviser was not forthcoming and precise in describing to investors or potential investors the adviser's controls over personal trading.³⁷

Another area that has drawn interest from the SEC is insider trading around private investments in public equities ("PIPEs").³⁸ PIPEs are dilutive to existing shareholders and when they are announced the price of the issuer's securities typically drops. For this reason, the mere fact that a hedge fund adviser has been contacted about a possible PIPE transaction could lead the SEC to believe that the adviser has received material non-public information about the issuer and therefore should be restricted in trading the issuer's securities.³⁹ As a result, SEC examiners have focused on advisers' policies and procedures to ensure that employees do not trade based on material non-public information received in connection with a PIPE offering.

Hedge fund advisers also should be aware that the SEC has also looked for evidence of insider trading in credit default swaps and other complex financial instruments. Earlier this year, the SEC brought its first insider trading enforcement action involving credit default swaps. The target of the action was a former hedge fund portfolio manager whom the SEC alleged was illegally tipped with information regarding a change in a proposed bond offering that was expected to increase the price of credit default swaps referencing the bonds.⁴⁰

Finally, the SEC has focused a lot of attention during the past year on the issue of hedge fund managers trading in connection with market rumors. Former OCIE Director Richards expressed concern that advisers are knowingly creating, spreading, or using false or misleading information with the intent to manipulate securities prices.⁴¹ This is consistent with Commissioner Walter's Congressional testimony that the SEC has been particularly focused on the connection between the spreading of rumors and short

selling at hedge funds.⁴² Basically, the SEC is concerned that a hedge fund employee could sell short an issuer's securities, spread a false rumor about the issuer, and ultimately profit if and when that rumor drives down the price of the issuer's securities.⁴³ Although the SEC has not yet provided guidance for investment advisers with respect to handling market rumors, hedge fund personnel should be on the lookout for false rumors spread by others seeking to profit from trading based on these rumors. Examiners will be paying special attention to whether advisers have in place policies and procedures designed to prevent firm personnel from spreading rumors and trading based on rumors.⁴⁴

D. Activities Outside Disclosed Strategies

When raising capital, fund managers typically represent they will invest the assets according to the investment program as disclosed in the offering documents and marketing materials. However, after a fund is launched, the manager may find that the disclosed strategies are not as successful as anticipated, or the manager might decide that other strategies, not disclosed, present promising opportunities for the funds. Also, the composition of a portfolio may shift from predominantly liquid to predominantly illiquid based on market conditions, such as the recent credit crisis, without any action taken by the manager.

Straying from the disclosed investment program is often referred to as "style drift" and may represent a breach of the manager's commitment to fund investors. Material deviations from the stated investment program are very significant to the Staff, regardless of whether the results were positive for investors. In this regard, SEC examiners have compared the investment program disclosed in offering documents and marketing materials with the actual investments made by the fund. The SEC also has looked at hedge fund advisers touting themselves as specialty funds (for example, "socially responsible funds" or "green funds") to ensure consistency between disclosure and practice.

It is essential that advisers monitor a fund's investment program in light of the disclosures made to investors not only when they came into the fund, but also during the life of the fund.⁴⁵ SEC Staff have found deficiencies where investments do not match or fit within the investment

program,⁴⁶ and they will expect advisers to have policies and procedures to monitor investments and identify any style drift.⁴⁷ The SEC's hedge fund fraud rule⁴⁸ treats material misrepresentations and omissions by advisers to investors or potential investors as fraudulent, without any required showing of bad intent on the part of the adviser.⁴⁹ Advisers should be prepared for the examination staff to review communications with investors for consistency and accuracy. In this regard, coordination between a firm's portfolio managers, investor relations, and legal and compliance officers is essential.

III. Additional Areas of Focus

OCIE has identified additional areas of focus in its examinations, several of which are of particular significance for hedge fund advisers.

A. Custody and Controls Over Investor Assets

The SEC is intently focused on issues involving custody and controls over investor assets, many of which have been highlighted by the Madoff case and other recently alleged Ponzi schemes. Amendments to the SEC's "Custody Rule,"⁵⁰ have been proposed (see below), and OCIE is conducting a sweep of investment advisers with certain risk characteristics, including advisers that use an affiliate to maintain custody of client assets.⁵¹ The SEC created a standardized form for requesting independent confirmations of assets from investors,⁵² and the Staff has been emphasizing custody and controls over investor assets as a part of regular periodic examinations of investment advisers.

Registered investment advisers, including hedge fund advisers, that have actual or deemed custody of client assets are subject to the requirements of the Custody Rule. During examinations, the SEC typically will review a hedge fund adviser's policies and procedures regarding safeguarding client assets. Examiners generally view the highest risk situations to be those where advisers maintain custody of assets directly and those where advisers with a dominant principal hold investor assets, especially where a small accounting practice is used as the auditor.⁵³ Hedge fund advisers should expect SEC examiners to verify custody of client assets on a sample basis with clients and custodi-

ans.⁵⁴ The SEC has suggested examiners will look at whether there is a process for regularly reconciling client and fund balances of securities owned with those shown by custodians and ensuring that the books reconcile.⁵⁵

The SEC's proposed amendments to the Custody Rule would impose an additional set of requirements on advisers, including: (1) an annual "surprise exam" of investment advisers that have custody, or are deemed to have custody, by an independent public accountant to verify client assets⁵⁶; and (2) where a related party of the adviser has custody, a custody control review by an accountant registered with, and inspected by, the Public Company Accounting Oversight Board.⁵⁷ Evaluating compliance with any new Custody Rule requirements will become an important part of the SEC's examination process.

B. Controls Over Valuation

Valuation of a fund's investment positions is a critical issue because the adviser typically receives management and performance fees based on the fund's net asset value. In addition, the SEC's examination staff has indicated it expects to see valuation policies and procedures that are detailed and tailored to the types of investments made by the fund⁵⁸ and, the more difficult it is to price an investment, the more scrutiny should be expected.⁵⁹ In addition to the pricing of specific categories of investments, the adviser's policies and procedures should address the process by which new investments are priced, and the mechanism by which pricing is determined (e.g., a valuation committee that is independent of portfolio management).⁶⁰ The market conditions of the past year, in particular the sudden illiquidity of so many investment positions, make controls over valuation critically important for hedge fund managers.

C. Supervision and Compliance

With the promulgation of the "Compliance Rule" in 2003,⁶¹ the SEC required registered investment advisers to have a designated Chief Compliance Officer and a compliance program including an annual review of compliance policies and procedures. As part of an SEC periodic examination, the Staff evaluates the adviser's compliance program, including whether the adviser has identified the relevant risks and implemented effective procedures to reduce those risks.⁶²

Frequent topics of review include: (1) supervision of non-U.S. offices⁶³; (2) the annual review of compliance procedures required by the Compliance Rule;⁶⁴ (3) implementation of new requirements under new laws or regulations; and (4) responsiveness to comments in SEC deficiency letters, including updating policies and procedures. The SEC also looks at changes to the adviser's organization and personnel, and considers whether the compliance program continues to be appropriate in light of those changes.⁶⁵ For example, following layoffs at many employers in late 2008, OCIE issued a statement reminding registered firms of the importance of maintaining an appropriately sized compliance staff.⁶⁶

D. Revenue Sharing

The SEC often takes a "follow the money" approach when examining hedge fund advisers. To the extent that advisers share revenue with third parties, examiners have looked to ensure that the relationship is disclosed to investors and that the revenue sharing is legitimate. The SEC also recently proposed new "pay to play" regulations that, if adopted, will significantly limit the ability of hedge fund advisers to use placement agents to secure public pension investments.⁶⁷ The SEC's proposed "pay to play" regulations follow the New York State Attorney General's announcement of investigations and indictments with respect to

payments made to intermediaries between certain investment funds and the New York State Common Retirement Fund.

E. Performance Reporting

The SEC considers it a best practice for advisers to use an outside firm to verify the adviser's investment performance claims.⁶⁸ Examiners commonly find a deficiency when hedge fund advisers who claim they comply with an outside firm's verification of performance do not actually do so.⁶⁹ Additional problems with performance reporting identified by OCIE include: (1) overstating returns; (2) failing to disclose whether results reflected dividends; and (3) advertising past specific performance.⁷⁰ As hedge fund managers attempt to raise additional capital in uncertain markets, they should be aware that greater attention may be paid to the presentation of their track records.

IV. Conclusion

The SEC continues to focus on hedge funds in its rulemaking, enforcement and examination programs, and this emphasis will only increase in light of recent Ponzi schemes and other frauds. To be ready for SEC examiners, hedge fund advisers must have a robust compliance program, an effective annual review process and an awareness of the current areas of examination focus.

ENDNOTES

¹ Samuel J. Hest, an associate at Schulte Roth & Zabel LLP, assisted in the preparation of this article.

² See *SEC Extends Form SH Short Sale Reporting Until Aug. 1, 2009, and Modifies Timing and Scope of Disclosure*, SCHULTE ROTH & ZABEL LLP CLIENT ALERT, Oct. 16, 2008; *SEC Issues Guidance on Form SH*, SCHULTE ROTH & ZABEL LLP CLIENT ALERT, Sept. 26, 2008; *SEC Amends Emergency Order Banning Short Sales of Financial Firm Securities*, SCHULTE ROTH & ZABEL LLP CLIENT ALERT, Sept. 23, 2009; *SEC Adopts New Short Sale Rules*, SCHULTE ROTH & ZABEL LLP CLIENT ALERT, Sept. 18, 2008.

³ *SEC Takes Steps to Curtail Abusive Short Sales and Increase Market Transparency*, SEC Press Release 2009-172 (July 27, 2009) (noting that the SEC will be taking three specific initiatives: (1) the daily publication by the SROs of short sale volume information; (2) the publication by the SROs of short sale

transaction information, on a one-month delayed basis; and (3) the publication by the SEC twice monthly of data of fails to deliver data); *SEC to Increase Public Disclosure of Short Selling*, SCHULTE ROTH & ZABEL LLP CLIENT ALERT, July 29, 2008.

⁴ See *SEC Seeks Comment on Alternative Uptick Rule*, SEC Press Release No. 2009-185 (Aug. 17, 2009); *SEC Seeks Comments on Short Sale Prices Test and Circuit Breaker Restrictions*, SEC Press Release No. 2009-76 (Apr. 8, 2009).

⁵ See, e.g., *The Regulator's view of hedge funds and hedge fund standards*, Hector Sants, Chief Executive, FSA, *Speech by FSA CEO* (Oct. 22, 2008) (discussing the FSA's new short sale rules); Christopher Cox, Former Chairman, SEC, *Speech by SEC Chairman: Opening Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission's Disclosure System* (Oct. 8, 2008) (noting that as part of the Enforcement Division's

investigation of potential manipulations of securities through abusive short selling and the intentional spreading of false rumors, the Commission approved orders requiring hedge funds, among others, to file statements under oath regarding certain trading and market activity); *Testimony Concerning Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions, Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (Sept. 23, 2008) (statement of Christopher Cox, Former Chairman, SEC) (noting that the SEC had taken measures to ease the "crisis in confidence in the markets," including a requirement of weekly short sale reporting by hedge funds and other large investment managers); *Testimony Concerning the SEC's Recent Actions with Respect to Auction Rate Securities, Before the H. Comm. on Financial Services*, 110th Cong. (Sept. 18, 2008)

- (statement of Linda Chatman Thomsen, Former Director, Division of Enforcement, SEC) (noting the Division of Enforcement's action alleging market manipulation based on a trader's circulation of false rumors as part of a short selling scheme).
- ⁶ Luis Aguilar, Commissioner, SEC, *Speech by SEC Commissioner: Hedge Fund Regulation on the Horizon -- Don't Shoot the Messenger* (June 18, 2009).
- ⁷ Mary Schapiro, Chairman, SEC, *Speech by SEC Chairman: Address to the Society of American Business Editors and Writers* (Apr. 27, 2009).
- ⁸ *Testimony Concerning the State of the Securities Markets Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (July 31, 2007) (statement of Former SEC Chairman Christopher Cox).
- ⁹ *Testimony Concerning Securities Law Enforcement in the Current Financial Crisis, Before the H. Comm. on Financial Services* (Mar. 20, 2009) (testimony of SEC Commissioner Elise B. Walter).
- ¹⁰ Robert Khuzami, Director, Division of Enforcement, SEC, *Speech by SEC Staff: Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement* (Aug. 5, 2009).
- ¹¹ U.S. Dep't of Treasury, Private Fund Investment Advisers Registration Act of 2009 (2009), available at <http://www.treasury.gov/press/releases/reports/title%20iv%20reg%20advisers%20priv%20funds%207%2015%2009%20fnl.pdf> (U.S. Department of the Treasury proposal); See *Analysis of Recent U.S. Regulatory Proposals Regarding Investment Advisers*, SCHULTE ROTH & ZABEL LLP CLIENT MEMORANDUM, July 30, 2009.
- ¹² *Testimony Concerning Examinations by the Securities and Exchange Commission and Issues Raised by the Bernard L. Madoff Investment Securities Before the H. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. (Jan. 27, 2009) (statement of Lori Richards, Former Director, OCIE) (the 14% figure includes routine examinations, "for cause" examinations, and "sweep" examinations).
- ¹³ Rick Ketchum, Speech to the Exchequer Club (June 17, 2009), available at <http://www.finra.org/newsroom/speeches/ketchum/p119009>.
- ¹⁴ See, e.g., *Regulators Defend Madoff Oversight*, N.Y. TIMES, Jan. 28, 2009 (citing Senator Christopher Dodd's comment that the Madoff fraud was a regulatory failure of historic proportions, "[b]ut what's more disturbing about it is that it went undetected until the perpetrator himself confessed."); *SEC regulators on defense at Madoff hearing*, MSNBC.COM, Jan. 27, 2009, available at <http://www.msnbc.msn.com/id/28872450/wid/18298287/> (citing Senator Charles Schumer's comment that "Madoff's fraud was so immense and obvious, and took place over such a long period of time, it is simply inexplicable how the SEC missed it."); Ross Kerber, *SEC chief cites agency's 'failures' in Madoff case*, BOSTON GLOBE, Dec. 17, 2008, at 9 (citing Representative Barney Frank, who called it "obviously appalling" that the SEC had missed early warnings of Madoff's fraud).
- ¹⁵ See Key Official to Exit SEC as Shake-Up Continues, WALL STREET JOURNAL at A20 (July 10, 2009) ("The SEC's inspector general is reviewing the agency's handling of the Madoff matter, with a report due out by August. It is widely expected to be critical of the examinations and enforcement groups. Some SEC watchers expect a shake-up in the examination division in response to the report's criticism.").
- ¹⁶ John Walsh, Chief Counsel, OCIE, *Speech by SEC Staff* (Mar. 24, 2009).
- ¹⁷ *Id.*; Lori Richards, Former Director, OCIE, *Speech by SEC Staff: Compliance Through Crisis: Focus Areas for SEC Examiners and Compliance Professionals* (Oct. 21, 2008).
- ¹⁸ *Testimony Concerning Securities Law Enforcement in the Current Financial Crisis, Before the H. Comm. on Financial Services* (Mar. 20, 2009) (testimony of SEC Commissioner Elise B. Walter).
- ¹⁹ *Id.*
- ²⁰ See *Testimony Concerning Hedge Funds, Before the S. Comm. on Banking, Housing, and Urban Affairs* (May 16, 2006) (testimony of Susan Ferris Wyderko, Former Director, Office of Investor Education and Assistance, SEC).
- ²¹ See 2009 CCO Outreach Regional Seminars, *The Evolving Compliance Environment: Examination Focus Areas* at 7 (Apr. 2009), available at <http://www.sec.gov/info/iaiccco/iaiccco-focusareas.pdf>.
- ²² *Id.*
- ²³ Roel C. Campos, Commissioner, SEC, *Speech by SEC Commissioner: Remarks before the SIA Hedge Funds & Alternative Investments Conference* (June 14, 2006).
- ²⁴ *SEC Charges 14 in Wall Street Insider Trading Ring*, SEC Press Release No. 2007-28 (Mar. 1, 2007) (quoting Former Chairman Christopher Cox's statement that "Our action today is one of several that will make very clear the SEC is targeting hedge fund insider trading as a top priority.").
- ²⁵ See *Testimony Concerning Insider Trading, Before the S. Comm. on the Judiciary* (Dec. 5, 2006) (testimony of Linda Chatman Thomsen, Former Director, Division of Enforcement).
- ²⁶ Luis Aguilar, Commissioner, SEC, *Speech by SEC Commissioner: Hedge Fund Regulation on the Horizon -- Don't Shoot the Messenger* (June 18, 2009).
- ²⁷ Lori Richards, Former Director, OCIE, *Speech by SEC Staff: Focus Areas in SEC Examinations of Investment Advisers: the Top 10* (Mar. 20, 2008).
- ²⁸ *Id.*
- ²⁹ *Id.*
- ³⁰ *Questions Advisers Should Ask While Establishing or Reviewing Their Compliance Programs* (May 2006), available at http://www.sec.gov/info/cco/adviser_compliance_questions.htm.
- ³¹ SEC ComplianceAlert July 2008, available at <http://www.sec.gov/about/offices/ocie/complialert0708.htm>.
- ³² *Id.*
- ³³ *Id.*
- ³⁴ *Id.*
- ³⁵ *Id.*
- ³⁶ *Id.*
- ³⁷ *Id.*
- ³⁸ See, e.g., *Testimony Concerning Insider Trading Before the S. Comm. on the Judiciary* (Sept. 26, 2006, as amended Oct. 5, 2006) (testimony of Linda Chatman Thomsen, Former Director, Division of Enforcement).
- ³⁹ See *SEC v. Cuban*, 2009 WL 2096166 (July 17, 2009) (in which the SEC alleged -- and the district court implicitly accepted -- that information regarding a PIPE offering that was transmitted to Mark Cuban constituted material non-public information; the district court ultimately held that Cuban had agreed only to keep the information confidential and had not agreed to refrain from trading the company's stock).
- ⁴⁰ *SEC Files First Credit Default Swap Insider Trading Case*, SEC Litigation Release No. 21023 (May 5, 2009).
- ⁴¹ Lori Richards, Former Director, OCIE, *Speech by SEC Staff: Compliance Through Crisis: Focus Areas for SEC Examiners and Compliance Professionals* (Oct. 21, 2008).
- ⁴² *Testimony Concerning Securities Law Enforcement in the Current Financial Crisis, Before the H. Comm. on Financial Services* (Mar. 20, 2009) (testimony of SEC Commissioner Elise B. Walter).
- ⁴³ See, e.g., *SEC Charges Wall Street Trader with Fraud for Spreading False Rumor*, SEC Litigation Release No. 20537 (Apr. 24, 2008) (announcing that the SEC settled a complaint for securities fraud and market manipulation relating to dissemination of a false rumor regarding an acquisition and concurrent short selling of the stock of the company rumored to be acquired).
- ⁴⁴ Lori Richards, Former Director, OCIE, *Speech by SEC Staff: Compliance Through Crisis: Focus Areas for SEC Examiners and Compliance Professionals* (Oct. 21, 2008).
- ⁴⁵ See, e.g., *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> (noting that as a best practice, hedge fund advisers should update or supplement private placement memoranda for material changes such as changes in the investment program).

Mutual funds with names that suggest investment in certain investments or industries are required to invest at least 80% of their assets in investments suggested by the name. Investment Company Act of 1940 Rule 35d-1. Subjecting hedge funds to such restrictions would seem inappropriate where a hedge fund's disclosure indicates the fund may make changes to its investment program.

⁴⁶ 2008 CCO Outreach Regional Seminars, *Top Deficiencies Identified in Examinations* at 14, available at <http://www.sec.gov/info/cco/topdeficiencies2008.pdf>.

⁴⁷ Lori Richards, Former Director, OCIE, *Put the Compliance Rule to Work: IA Compliance Best Practices Summit* (Mar. 15, 2004).

⁴⁸ Advisers Act Rule 206(4)-8.

⁴⁹ Advisers Act Rule 206(4)-8 provides: "It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act for any investment adviser to a pooled investment vehicle to:

- Make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or
- Otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle."

"Pooled investment vehicle" is defined under Rule 206(4)-8 as any investment company as defined in section 3(a) of the Investment Company Act of 1940 or any company that would be an investment company under section 3(a) of that Act but for the exclusion provided from that definition by either section 3(c)(1) or section 3(c)(7) of that Act.

⁵⁰ Advisers Act Rule 206(4)-2.

⁵¹ Lori Richards, Former Director, OCIE, *Speech by SEC Staff: Strengthening Examination Oversight: Changes to Regulatory Examinations* (June 17, 2009).

⁵² See *Requests for Independent Confirmation of Assets*, available at http://www.sec.gov/about/offices/ocie/routine_account_information_confirmation.pdf.

⁵³ Alex Viall, *SEC initiatives and top 13 SEC exam priorities -- SIFMA C&L 2009*, COMPLINET (Mar. 30, 2009).

⁵⁴ *Id.*

⁵⁵ See 2009 CCO Outreach Regional Seminars, *Safeguarding Clients' Assets Under Management Through Asset Verification and Reconciliation* (Apr. 2009), available at <http://www.sec.gov/info/iaiccco/iaiccco-custody.pdf>.

⁵⁶ *SEC Proposes Rule Amendments to Strengthen Safeguards of Investor Funds Controlled by Investment Advisers*, SEC Press Release No. 2009-109 (May 14, 2009).

⁵⁷ *Id.*

⁵⁸ See 2009 CCO Outreach Regional Seminars, *The Evolving Compliance Environment: Examination Focus Areas* at 19 (Apr. 2009).

⁵⁹ Lori Richards, Former Director, OCIE, *Speech by SEC Staff: Focus Areas in SEC Examinations of Investment Advisers: the Top 10* (Mar. 20, 2008).

⁶⁰ *Id.*; See also *Best Practices for the Hedge Fund Industry*, Report of the Asset Managers' Committee to the President's Working

Group on Financial Markets at 14 (Jan. 15, 2009), available at <http://www.amaicmte.org/Public/AMC%20Report%20-%20Final.pdf> (noting that as a best practice, hedge fund advisers should establish "a comprehensive and integrated valuation framework to provide for clear, consistent valuations of all the investment positions in the fund's portfolio, while minimizing potential conflicts that may arise in the valuation process.").

⁶¹ Rule 206(4)-7.

⁶² Lori Richards, Former Director, OCIE, *Speech by SEC Staff: Focus Areas in SEC Examinations of Investment Advisers: the Top 10* (Mar. 20, 2008).

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ Lori Richards, Former Director, OCIE, *Speech by SEC Staff: "Compliance in Today's Environment: Step Up to the Challenge" -- Remarks Before the IA Compliance Best Practices Summit 2009* (Mar. 12, 2009).

⁶⁶ Open Letter to CEOs of SEC-Registered Firms (Dec. 2, 2008), available at <http://www.sec.gov/about/offices/ocie/ceoletter.htm>.

⁶⁷ See *SEC Proposes Measures to Curtail "Pay to Play" Practices*, SEC Press Release No. 2009-168 (July 22, 2009).

⁶⁸ Lori Richards, Former Director, OCIE, *Speech by SEC Staff: "Compliance in Today's Environment: Step Up to the Challenge" -- Remarks Before the IA Compliance Best Practices Summit 2009* (Mar. 12, 2009).

⁶⁹ See 2008 CCO Outreach Regional Seminars, *Top Deficiencies Identified in Examinations* at 6, available at <http://www.sec.gov/info/cco/topdeficiencies2008.pdf> (identifying a top deficiency as inaccurate claims of compliance with Global Investment Performance Standards "GIPS").

⁷⁰ *Id.*

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