



Schulte Roth & Zabel

SEC Investigation Response for Asset Managers:

HOW TO PREPARE AND MISTAKES TO AVOID

June 18, 2014

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Agenda



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- **Welcome – Mary O'Connor, Global Head Financial Institutions Group, Willis Group**
- **Panelist Introductions – Richard Magrann-Wells, Senior Vice President, North American Financial Institutionals Group, Willis Group**
- ***Key Areas of SEC Scrutiny* – Chris Lombardy, Partner, Kinetic Partners**
- ***SEC Enforcement Actions* – Gary Stein, Partner, Schulte Roth & Zabel**
- ***Insurance Implications: SEC Policy on Admissions* – Ted Keyes, Special Counsel, Schulte Roth & Zabel**
- ***Fund Manager Coverage Issues* – Bob Herm, Vice President, Axis Insurance**
- **Q&A**

Key Areas of SEC Scrutiny, Chris Lombardy

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National Exam Program (“NEP”)

- **Newly framed mission of The Office of Compliance Inspections and Examinations (“OCIE”)**
 - Prevent fraud
 - Improve compliance
 - Inform policy
 - Monitor risk

- **Presence Exam Initiative**
 - Engagement, examination, and reporting

SEC Exam Process

■ What we're seeing

- Request letter (see Page 12)
- Two–three examiners
- Two–five days average onsite
- SEC findings letter
- Response letter

Ensure all actions in response letter have been implemented

■ OCIE conducting “Checkup Exams”

Key Areas

- Custody
- Accounting related issues
- Marketing materials
- Valuation
- Private equity related issues
- Research process
- Trading and brokerage related issues
- Cybersecurity

Related Issues

Accounting-Related Issues

- Cash movement
- Fund financials
- Management company financials
- Expenses

Private Equity-Related Issues

- Analysis of deal fees and break-up fees
- Board membership on portfolio companies
- Potential broker registration

Marketing Materials

■ Process for approving

■ Key areas

- Net of fee returns
- Maintain backup data for performance
- Use of trade/investment examples
- No superfluous language
- Disclaimer language
 - Use of indices
 - Risks
 - Do not guarantee performance

Research Process

- MNPI concerns
- Expert network groups
- Meetings with public companies
- Conference attendance
- Idea dinners

Trade and Brokerage Related Issues

- **Aggregation and allocation**
 - Documentation of non-pro-rata allocation
- **Trade errors**
- **Soft dollars**
- **Best Execution**
- **Regulation M violations**
- **Periodically sample specific trades**

OCIE's Cyber Security Initiative

- **SEC's Office of Compliance Inspections and Examinations ("OCIE") will conduct examinations of more than 50 broker-dealers and registered investment advisers focusing on areas related too cybersecurity including:**
 - Identification and assessment of cybersecurity risks
 - Protection of networks and information
 - Risks associated with remote customer access and funds transfer requests
 - Risks associated with vendors and other third parties
 - Detection of unauthorized activity
- **Initiative is designed to asses cybersecurity preparedness and to obtain information about the industry's recent experiences with certain types of cyber threats**
- **What should advisors do next?**

Other Key Topics

- Office sharing
- Value added investors
- Private investments by employees
- Independent research consultants
- Communication among analysts at different firms
- Email communication review

General Items Requested

1. Compliance Manuals
2. Audited fund financials and management company financials
3. Marketing materials and RFPs
4. A list of brokerage accounts for employees and statements
5. Employee private investments
6. Trade data for client accounts
7. Trade error documentation
8. Service provider information
9. Sub-advisory arrangements
10. Agreements with independent research consultants
11. Organizational chart of employees and entities
12. A list of cross trades and principal trades
13. Valuation Policy
14. Employee attestation of Compliance Manuals
15. Office sharing arrangement
16. Log of any compliance breach

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SEC Enforcement Actions, Gary Stein

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The Statistics: An Increased Focus on Investment Advisers

- SEC brought 686 cases in FY 2013, vs. 734 (FY 12) and 735 (FY 13)
- Investigations up 13% and formal orders of investigation up 20%
- Averaging 144 cases per year involving investment advisers/companies in FY 11-13 – single largest category
 - Average of 81 cases per year from FY 07-09

Issues that Typically Lead to Investment Adviser Enforcement Actions

- Valuation issues
- Allocation of investments and allocation of fees and expenses
- Rule 105 of Regulation M
- Misstatements/omissions in communications with investors
- Insider trading

What To Do When SEC Enforcement Comes Knocking

- **Notify insurance carrier**
- **Document preservation**
- **Retention of counsel**
- **Protect the privilege**
- **Disclosure issues:**
 - Employees
 - Investors
 - Counterparties

SEC Enforcement Trends

- **Cooperating witnesses**
- **Whistleblower program**
 - Paradigm Capital case (6/16/14)
- **“Broken windows” policy**
- **FCPA and AML**
- **Administrative proceedings**
- **More cases going to trial**
 - But not necessarily ending well for the SEC

Evolution of the SEC's “No Admission” Policy

- No-admit, no-deny policy
- Judge Rakoff's decision in *Citigroup*
- 2012: SEC to require admissions by parties who have pled guilty
- 2013: SEC to require admissions in certain other cases
 - Harbinger Capital Partners case
- Court of Appeals decision in *Citigroup*

Insurance Implications: SEC Policy on Admissions

Theodore Keyes

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Insurance Implications: SEC Policy on Admissions in Settlements

- Defense costs — advancement and clawback
- Conduct exclusions
- Non-imputation and severability clauses

Advancement of Defense Costs

- Contrast to duty to defend clause
- Defense costs for covered claims are advanced
- Subject to allocation for costs related to non-covered claims or persons
- Subject to right to clawback (if it turns out claims were not covered)

Conduct Exclusions

- **Deliberate fraudulent or criminal acts; dishonest conduct**
- **Illegal profits**
- **Final adjudication clause**
 - Underlying action
 - Non-appealable

Settlement with SEC

- Implications of an admission
- Is the admission in the settlement a final adjudication?
- If it is a final adjudication:
 - Loss is excluded
 - Defense costs going forward are not covered
 - Potential clawback of defense costs previously reimbursed
 - Likely no coverage for related civil actions

What Constitutes a Final Adjudication

- Limited case law
- Judicial ruling on the merits (and appeal)
- Guilty plea
- Settlement approved by court?
 - Terms of settlement
- Administrative settlement?

Non-Imputation Clause

- Conduct exclusions
- Bad Acts of one individual insured are not imputed to other individual insureds
- Conduct of certain individuals may be imputed to the insured entity

Severability Language

- Representations in Application
- Definition of Application
- Is knowledge imputed to individual insureds other than signatory?
- Is knowledge imputed to the entity?

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Hedge Fund Coverage Issues, Robert J. Herm

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SEC Investigations

- **Stages of SEC investigative process is a multi-step process that generally proceeds in the following order.**
 - **Triggering Event:** Can be largely anything, including news articles, investor complaints, anonymous tips including whistleblowers, etc.
 - **Informal Inquiry** (also known as Matter under Inquiry): Generally involves a request for information from the company to provide information or documents, but can also involve requests to interview individuals or take voluntary testimony. There is a very low threshold for the SEC to initiate to open an informal inquiry.
 - **Formal Order of Investigation** may be issued by the Enforcement Director or certain other designated individuals. This grants the SEC:
 - subpoena power to compel document production from the company and potential third parties such as banks or counterparties.
 - authority to administer oaths in connection with sworn testimony, which generally follows document production.
 - **Wells Notice:** If the SEC staff feels that charges are appropriate, they routinely issue a Wells Notice which provides a basic outline of what they deem the inappropriate conduct to have been and relief that the staff will seek, but also provides the target an opportunity to provide one final response as to why they do not feel they should be charged

Insurance Coverage Implications of SEC Investigations

■ Elements of Definition of Claim for Investigations:

- Claims means ... A civil, administrative or regulatory investigation against any Insured commenced by a subpoena or written notice identifying as an entity person against whom a formal proceeding may be given; or
- Claim means ... In the case of an investigation by the SEC ... The service of subpoena upon an individual or service of a subpoena upon an Insured other than Individual Insured where the subpoena defines the Insured as a party against whom a proceeding may be commenced
- ... For a Wrongful Act

■ Coverage issues that arise:

- “Service of a subpoena” – per the previous slide this only occurs at the Formal Investigation stage. Policies currently in the market do not generally provide coverage for informal investigations since the policies are not priced to include coverage for all SEC document requests
 - Note that a few policy forms in the market place used to state “Claim includes informal investigations”, but they would then define “informal investigation” as requiring a subpoena
 - Note also that service of a “subpoena” will not include costs incurred in corresponding with the SEC during a routine examination
- “Is the insured a target?” Coverage requires a Wrongful Act to be alleged, which can be broadly defined as a “negligent act, error or omission, actual or alleged breach of duty, etc.” but as respects natural persons, it often references “matters against Insured Persons in their capacity as such”.
 - Is the SEC request merely part of an industry sweep to gather data on particular business practices in a niche?

New Coverage Enhancements in the Market

- **There has been substantial give and take between insureds and their brokers and coverage counsel, versus insurers on the claim definition for investment advisers and hedge funds, as well as publicly traded companies at both the policy negotiation and specific claim levels.**
 - Over the past several years, a coverage enhancement generally referred to as “Interview Costs” was introduced in the publicly traded insured D&O market to provide some coverage for legal fees incurred by a natural person where they are retaining their own counsel to respond to SEC requests to interview insured persons related to the operations of the insured.
 - Sample wording might include: “A verifiable request from an Enforcement Body that an Insured Person of any Insured Organization a) appear at an interview, or b) produce documents in their sole possession, relating to their activities with the Organization” ... Such requests shall not include any sweeps, routine audits or similar processes that is not part of an Enforcement Body’s routine review process. Covered costs may include reasonable and necessary costs incurred by a natural person in connection with their preparation and response to a Pre-Claim inquiry, including legal fees if they have chosen to retain their own counsel,
 - This wording does not generally require a “Wrongful Act” to be alleged, nor does it have any “formal” triggers.
 - Its scope is limited however by the requirement that the insured person be using their own counsel and routine SEC exams are not covered – this is not intended to provide coverage to responses to routine SEC inquiries where the firm and employee share common counsel.
 - In the HF space, this is occasionally appearing on large hedge funds with high retentions and favorable loss histories.

Definition of Loss

- **The Definition of Loss in virtually all policies excludes “matters uninsurable under applicable law.” Public policy generally forbids a wrongdoer from having to disgorge improper benefits but then obtain an insurance recovery to make the alleged wrongdoer whole.**
 - SEC Settlements often require an individual or corporation to disgorge trading profits, fees, or other financial payments.
 - There is a substantial body of case law on what constitutes uninsurable disgorgement, especially in New York, with case law including:
 - a New York appellate court held that a policyholder could not obtain recovery from its E&O insurer where the SEC’s finding “conclusively linked” the disgorgement payment to the funds obtained by the policyholder.
 - the New York Court of Appeals overturned an underlying Court’s grant of summary judgment in favor of several insurers where the SEC described a settlement amount as “disgorgement”, even though the improper payments were never received by the policyholder/defendant since the SEC “disgorgement” reference was to third parties obtaining improper payments due to the policyholder/defendant’s conduct.
 - Definition of Loss often includes a provision that “*Loss, other than Defense Expenses*, shall not include: [taxes, fines, penalties, matter uninsurable under applicable law”.

Side A-DIC (Difference in Conditions) Policies

- **“A-DIC” policies only respond to Claims against Insured Persons that: a) are not indemnified by other sources, typically due to financial inability to indemnify, their employer is prohibited by law from indemnifying, or their employer could indemnify under applicable law but refuse to do so, and b) coverage is excess of underlying insurance, unless the underlying insurance does not cover the Claim.**
 - Because it only responds to Claims against natural persons (i.e., the Adviser and Funds re not insureds) that are not indemnified, the coverage grants are much broader via fewer exclusions compared to traditional D&O/E&O policy.
 - These policies are generally intended to “backstop” to protect natural persons from personal liability arising from: a) the underlying D&O/E&O policy being exhausted due to claims against the corporate entity and/or insured persons; or b) the underlying D&O/E&O policy not providing coverage due to its terms and conditions or material misrepresentation in its Application; and c) non-indemnifiable claims as described in a) above (*perhaps due to regulatory pressure?*).
 - Note that typical D&O/E&O policies generally include “presumptive indemnification” clauses to prevent an insured from using its sole discretion to refuse to indemnify a natural person to take advantage of the \$0 retention (or \$1,000 - \$5,000 for NY) for non-indemnifiable claims.

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