Alternative Insight

PRIVATE FUND DISPUTE RESOLUTION

A practical guide to managing and reducing litigation risk at the fund, investor and portfolio-company level

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Navigating the regulatory landscape and avoiding common missteps

By Harry S. Davis and Brian Burns, Schulte Roth & Zabel LLP

Editor's foreword

Harry Davis and Brian Burns offer a comprehensive outline of the UK and US regulatory compliance and enforcement environment to which private investment funds are subject together with a detailed discussion of the examination process as well as the enforcement process followed by regulators. The chapter also contains a detailed discussion of the range of infringements that might result in regulatory enforcement actions and/or criminal prosecutions and the remedies and penalties (monetary and otherwise), which may be imposed for such infractions. Practical case studies are drawn from the authors extensive experience in this area. This chapter is an essential framework for understanding the regulatory and enforcement process and for navigating safely the many dangers that can trip up the unwary. □

Hilton Mervis

Introduction

Private investment funds today face layers of regulation from regulatory bodies in different jurisdictions. Many of these regulators work in coordination with each other and, as a result, private funds may find themselves facing simultaneous inquiries, investigations or enforcement actions involving multiple regulators. Having an understanding of those regulatory authorities, the types of issues they seek to address and how they do so is therefore a good starting point for avoiding the missteps that have gotten other private investment funds into trouble in the past.

This chapter examines the regulatory environment in which private funds operate in 2014. In particular, it focuses on the US Securities and Exchange Commission (SEC) and US Department of Justice (DOJ) and the UK's Financial Conduct Authority (FCA). The process followed in investigations by these authorities and the types of actions they tend to bring against private funds is set out below. The chapter also discusses the extraterritorial application of the US securities laws and the remedies available to the authorities in the US.

As each investigation or enforcement action is different, this chapter only offers an overview of and broad guidance on the regulatory environment.

Overview of US regulatory bodies

SEC

The SEC is the federal agency with primary authority for enforcing US securities laws. It carries out its responsibilities through five divisions and each is tasked with different aspects of the agency's business.

The SEC's Division of Enforcement is tasked with investigating potential securities law violations and recommending enforcement proceedings, either in federal court or before an administrative law judge, to the Commissioners. The SEC brings hundreds of civil enforcement actions each year against potential securities law violators. Of particular interest to the private investment community are three of the Enforcement Division's specialised units:

- *Asset Management Unit,* which focuses on investment advisers and the funds they advise.
- *Market Abuse Unit,* which focuses principally on insider trading and market manipulation violations.
- *Structured and New Products Unit,* which focuses on structured products and new products, including CLOs, CDOs, credit default swaps and other innovations in the securities markets.

DOJ

The DOJ and the United States Attorneys' Offices (USAO) enforce the US criminal laws. DOJ can and does work alongside the SEC to criminally prosecute certain violations of the securities laws (the SEC has only civil jurisdiction). DOJ may also bring charges against securities law violators for more general federal crimes, such as mail or wire fraud, in addition to charges based on specific federal securities law statutes.

CFTC

The Commodity Futures Trading Commission (CFTC) regulates the commodity futures and options markets with the goal of preventing excessive speculation, price manipulation and fraud.

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) expanded the CFTC's jurisdiction to cover previously unregulated over-the-counter derivatives like swaps. Many participants in swap transactions must now register with the CFTC and meet its capital requirements. Because of the increasing use of swaps by private investment funds, CFTC enforcement is likely to increase.

State securities regulators/state prosecutors

Each US state has its own securities laws as well as state regulators responsible for enforcing them. These laws differ from state to state,[1] but as a general rule cover many of the same subjects as federal securities laws. However, state laws generally apply only to securities sold or persons selling them within the state.

Under federal law, offerings of certain 'covered securities' are exempt from state laws governing the registration of securities offerings,[2] but federal law does not limit the ability of state securities regulators to investigate and bring actions for fraud

[1] *State Securities Regulators*, US Securities and Exchange Commission at: www.sec.gov/answers/statesecreg.htm.

[2] 15 USC § 77r (a)–(b).

that violate state law.[3] Anyone in violation of the securities laws may therefore find themselves confronting investigations by regulators at both the state and federal level.

State prosecutors and attorneys general may also bring criminal charges for violations of state securities laws as well as more general state criminal laws. In fact, some state laws offer fewer hurdles to prosecution than some federal laws and can therefore be a powerful tool in the hands of state prosecutors, regardless of whether the SEC or DOJ is pursuing an investigation or action.[4]

State prosecutors and state securities regulators often coordinate their investigations with the SEC and USAO/DOJ, but are not required to do so; sometimes they conduct their own investigations and bring their own enforcement actions/prosecutions regardless of what the SEC or the USAO/DOJ is doing on the same matter.

Overview of UK regulatory bodies

FCA

The FCA is tasked with protecting consumers, enhancing the integrity of the UK's financial system and promoting effective competition in consumer markets. It has the power to regulate the marketing of financial products and to set minimum standards for those products. Importantly, the FCA also has enforcement powers, including the authority to pursue criminal prosecutions.

SFO

The UK Serious Fraud Office (SFO) is tasked with investigating and prosecuting serious or complex frauds, bribery and corruption. It focuses on gathering information, analysing it and bringing appropriate cases seeking civil recovery and/or criminal penalties. It often works in coordination with the FCA and other UK and international authorities in pursuing investigations.

Regulatory and criminal investigations: Processes and procedures

The authorities described above have the power to investigate and bring enforcement actions and/or criminal prosecutions in their respective areas of responsibility. Each entity follows its own practices and procedures during an investigation and understanding them can help in navigating the often complex landscape of regulatory and criminal investigations. This section examines the mechanics of examinations and investigations conducted by the SEC, USAO/DOJ and FCA.[5]

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[3] 15 USC § 77r (c)(1).

[4] New York's Martin Act is an example. See N.Y. Gen. Bus. L. Art. 23-A; Michael J. De La Merced, In *JPMorgan Case*, the Martin Act Rides Again, *New York Times* (October 2, 2012), available at: http://dealbook.nytimes.com/2012/10/02/in-jpmorgan-case-the-martin-act-rides-again/?_r=0.

[5] It is beyond the scope of this book to delve into the process and procedure followed in state securities and state criminal investigations and enforcement actions/prosecutions given the multiplicity of different jurisdictions.

SEC investigations

The SEC conducts two major types of inquiries:

1. ***Compliance examinations,*** conducted by the SEC's Office of Compliance Inspections and Examinations (OCIE).
2. ***Enforcement investigations,*** conducted by the SEC's Division of Enforcement.

Compliance examinations, unlike enforcement investigations, are often conducted as a matter of routine and, on their own, do not entail the possibility of legal proceedings or civil penalties. However, OCIE can, and often does, refer matters to the Division of Enforcement when the results of a compliance examination merit it.

Compliance examinations

OCIE conducts compliance examinations of entities that are registered with the SEC pursuant to a number of different provisions of the federal securities laws.[6] With the passage of Dodd-Frank, OCIE now has the power to examine advisers of certain private investment funds (including advisers to hedge funds, funds of funds and private equity funds) that previously had been exempt from SEC registration,[7] and in 2013 OCIE designated the examination of private investment fund 'new registrants' as a priority.[8]

These examinations are conducted to test firms' compliance with federal securities laws and to determine the safety of client assets. An examination typically involves OCIE reviewing an organisation's books and records, interviewing its management and employees, and conducting an on-site inspection of its offices.

The scope of an examination depends on the risks presented by the firm in question. OCIE sometimes acts on tips, complaints, and referrals, which may inform the scope of its examination. In other cases, OCIE seeks to uncover risks and to understand the firm's compliance culture and internal control environment.

While the focus of any particular exam depends, at least in part, on the examinee's individual circumstances, OCIE has identified certain areas as priorities, including the safety and custody of client assets, conflicts of interest relating to compensation arrangements and the accuracy of marketing materials and performance data.[9]

OCIE may take a number of different actions once an examination is complete, including:

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[6] See 15 USC §§ 78q (a)-(b), 80a-30 (a)-(b), 80b-4.

[7] Office of Compliance Inspections and Examinations, Examinations by the Securities and Exchange Commission's Office of Compliance Inspections and Examinations, § I.C.5.b (February 2012) (OCIE Guide); see Dodd-Frank Act § 403–04 (amending 15 USC §§ 80b-3(b) and 80b-4); see also Dodd-Frank Act § 402 (defining 'private fund' as *"an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act . . . but for section 3(c)(1) or 3(c)(7) of that Act"*).

[8] Office of Compliance Inspections and Examinations, Examination Priorities for 2013, at 5 (February, 21, 2013), at: www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf (OCIE, Examination Priorities).

[9] OCIE, Examination Priorities, *supra*, at 3–4.

- *Closing the examination.* An examinee may receive a short letter confirming the examination is closed if OCIE has found no deficiencies in its compliance programme. However, OCIE has cautioned that this does not necessarily amount to a 'clean bill of health'.[10]
- *Issuing a deficiency letter.* If deficiencies are identified, the examinee may receive a letter identifying the deficiencies, asking for a written response and for remedial action to be taken.[11] A relatively high percentage of examinations result in the issuance of a deficiency letter.
- *Calling a special meeting or conference call.* When the issues identified are too serious for a basic deficiency letter, but not serious enough to warrant a referral to the Division of Enforcement, the deficiencies and potential solutions will be discussed with management in a meeting or call and will be followed by a formal deficiency letter.[12]
- *Referring the matter to the Division of Enforcement.* Serious issues of non-compliance or potential violations of the securities laws may be referred by OCIE to the SEC's Division of Enforcement for further investigation and, potentially, for an enforcement action (see below). This is especially likely when OCIE concludes that investor funds are 'at risk.' Many of the SEC's enforcement actions each year come from such referrals.[13]

Enforcement investigations

Enforcement investigations are undertaken for the specific purpose of investigating potential violations of the federal securities laws and determining whether or not to bring an enforcement action against a firm or its personnel.

Investigations can be informal (that is, there is no formal order of investigation in accordance with the SEC's established rules) or formal (a formal order is issued in the name of the Commission). Both informal and formal investigations are often prompted by referrals from OCIE, self-regulatory organisations or from other state or federal agencies as well as media reports and/or complaints from investors and calls to the SEC's 'tip line,' among other sources.

All investigations (both informal and formal) are non-public, unless otherwise ordered by the SEC.[14]

Informal investigations

Informal investigations are known as Matters Under Inquiry (MUIs). The key distinction between an MUI and a formal investigation is that in the former the Division of Enforcement has no subpoena power and therefore cannot compel individuals or entities to produce documents or provide testimony. It must rely instead on the voluntary

[10] OCIE Guide, *supra*, § II.H.1, at 29.
[11] OCIE Guide, *supra*, § II.H.1, at 29–30.
[12] OCIE Guide, *supra*, § II.H.3, at 30.
[13] OCIE Guide, *supra*, § II.H.4, at 30.
[14] 17 CFR § 203.5.

cooperation of those involved. This distinction may be largely illusory, however, since one of the fastest ways to have an MUI morph into a formal investigation is to refuse to cooperate voluntarily with the investigation.

MUIs are generally considered to be preliminary in nature. An MUI may therefore be opened based on incomplete information in an effort to gather sufficient facts to determine whether a formal investigation is warranted.

To open an MUI, a staff member of the Division of Enforcement must submit a request through an internal database and provide basic information about the proposed MUI. The request must then be approved by the staff member's supervisor. No formal action by the SEC or Director of Enforcement is required to open an MUI.

During MUIs, the voluntary production of documents will be requested. Witnesses may also be asked to be voluntarily interviewed by the staff, either in person or by telephone. It is worth noting that even if not under oath, a witness may still face penalties for any false statements.[15]

MUIs generally should be closed or converted to formal investigations within 60 days.[16] To close an MUI, the assigned staff member at the Division of Enforcement must obtain approval from a supervisor and provide a narrative explanation of the reasons for closing the investigation.[17] Since closing an MUI is easier than closing a formal investigation (which requires a more detailed analysis of the facts and the investigative steps taken, as well as approval from an associate director of the Division of Enforcement), the entity or person under investigation should seriously consider, where appropriate, cooperating with the staff and attempting to resolve an MUI as quickly as possible in order to prevent conversion to a formal investigation.[18]

Formal investigations

The Division of Enforcement staff must obtain a formal order of investigation in accordance with established SEC rules to conduct a formal investigation. Once obtained (whether by converting an MUI or independently of an MUI), the Division of Enforcement has the power to subpoena individuals and entities to produce documents or provide testimony.[19] Indeed, this is the primary motivation for obtaining an order. It is not in any way a finding that any actual violations of the securities laws have occurred.[20]

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[15] See 18 USC § 1001 (providing criminal penalties for false statements to government officials).

[16] Securities and Exchange Commission, Division of Enforcement, Enforcement Manual, § 2.3.1, at 16 (October 9, 2013) (SEC Enforcement Manual).

[17] SEC Enforcement Manual, *supra*, § 2.3.2, at 18–19.

[18] Colleen P. Mahoney et al., *The SEC Enforcement Process: Practice and Procedure in Handling an SEC Investigation*, A-12 (2011) (Mahoney).

[19] See 15 USC §§ 77s(c), 78u(b), 80a-41(b), 80b-9(b) (granting the Commission or its designee subpoena power); 17 CFR § 202.5(a) (authorising the use of 'process' in formal investigations).

[20] Mahoney, *supra*, at A-17.

Since 2009, senior officers in the Division of Enforcement have had the authority to issue formal orders of investigation.[21] Prior to that time, Division of Enforcement staff was required to obtain formal orders of investigation from the five commissioners of the SEC.[22]

To obtain a formal order, a memorandum and a draft of a proposed formal order must be submitted to and approved by a senior enforcement official.[23] The formal order describes the nature of the investigation and designates specific staff members to act as officers of the SEC in the conduct of the investigation.[24] The formal order typically identifies the parties involved in the underlying conduct and provides a description of the potential violations, including references to the provisions of the securities laws potentially violated. The descriptions of the potential violations are generally quite broad and often do little more than track the language of the relevant statutes. Nonetheless, they may provide some insight into the types of issues the Division of Enforcement staff views as relevant.

Anyone receiving a subpoena can request to be 'shown' the formal order and, with the approval of an appropriate official, is entitled to receive a copy of it for 'retention.'[25] Requests for a copy for 'retention' must be in writing and contain a representation that the requester will keep the order confidential.[26] Although generally granted, these requests may be denied if the official believes the person requesting the copy will not keep it confidential or will use it for purposes unrelated to the investigation.[27]

In the course of the investigation, documents and testimony from witnesses will be subpoenaed. With respect to documents, the recipient of the subpoena (and its legal counsel) must act quickly to preserve any documents that the person or entity has, which are relevant to the investigation (many subpoenas include a description of categories of documents to be preserved, which may be broader than the subset of documents that must be produced in response to the subpoena).

Failure to preserve documents can result in significant penalties (including, potentially, criminal prosecution for obstruction of justice).[28] Legal counsel may find it useful to negotiate the scope of the subpoena in order to narrow the categories of documents that must be produced in response to the subpoena. Narrowing the universe of responsive documents reduces the burden on the firm of complying with the subpoena.

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[21] 17 CFR § 200.30-4(a)(13); SEC Enforcement Manual, *supra*, § 2.5.3.

[22] Schulte Roth & Zabel LLP, *Insider Trading Law and Compliance Answer Book 2014*, at 513 (Harry S. Davis ed., 2013) (Insider Trading Law and Compliance).

[23] SEC Enforcement Manual, *supra*, § 2.3.4.

[24] SEC Enforcement Manual, *supra*, § 2.3.4.

[25] 17 CFR § 203.7(a).

[26] SEC Enforcement Manual, *supra*, § 2.3.4.2, at 21; see 17 CFR § 203.7(a) (request for a copy for retention must be *"consistent both with the protection of privacy of persons involved in the investigation and with the unimpeded conduct of the investigation"*).

[27] SEC Enforcement Manual, *supra*, § 2.3.4.2, at 21.

[28] See 18 USC § 1519 (imposing criminal penalties for knowingly destroying or concealing records with the intent to impede or obstruct an investigation).

The Enforcement staff often agrees to this (at least initially) without prejudicing its right to request additional documents at a later date. Figuring out what documents are important to the investigation and producing those quickly can often result in the rest of the subpoena's requests being deferred or a firm being excused from producing the rest of the documents sought.

When a witness is subpoenaed to testify, the testimony is given under oath, usually in the regional office of the SEC conducting the investigation. The testimony is likely to be recorded and a transcript prepared afterwards. During the testimony, the witness may be represented and accompanied by legal counsel[29] and may assert the Fifth Amendment privilege against self-incrimination, the attorney-client privilege or the work product doctrine,[30] to the extent applicable.[31]

Witnesses can review the transcript of their testimony[32] and are generally entitled to a copy of it, unless the staff determines that there is 'good cause' to deny the request.[33] In the event that a request is denied, a witness may still inspect the transcript.[34] It is advisable to request a copy of the transcript at the time the testimony is taken. A transcript request form must be completed, and can be obtained from the SEC staff member taking the testimony.

The Wells Process

If the staff conducting the investigation deems an enforcement action or administrative proceeding appropriate, authorisation to bring the action or proceeding must be obtained from the SEC.

Before seeking authorisation, the Enforcement staff generally provides a Wells Notice to the person or entity against whom an enforcement action is contemplated. The Wells Notice states the staff's intention to recommend an enforcement action to the SEC and identifies the securities law provisions that are believed to have been violated.[35] It also notifies the firm or persons that they may make a submission (a Wells submission or Wells memorandum) to the staff, senior officials in the Division of Enforcement and the SEC regarding the proposed recommendation to commence an enforcement action.

The staff conducting the investigation has discretion to provide a Wells Notice, and the entire Wells process is informal.[36] The SEC can dispense with the Wells process in

[29] 17 CFR § 203.7(b); SEC Enforcement Manual, *supra*, § 3.3.5.2.2.

[30] The work product doctrine protects documents or information prepared by a party or its counsel in connection with or in anticipation of litigation from having to be produced in discovery to a regulator, private litigant or other adverse party.

[31] SEC Enforcement Manual, *supra*, §§ 4.1.1 (attorney-client privilege), 4.1.2 (attorney work product), 4.1.3 (Fifth Amendment privilege).

[32] 17 CFR § 203.6.

[33] 17 CFR § 203.6.

[34] 17 CFR § 203.6.

[35] SEC Enforcement Manual, *supra*, § 2.4.

[36] SEC Enforcement Manual, *supra*, § 2.4, at 22; see *Wellman v. Dickman*, 79 F.R.D. 341, 352–53 (S.D.N.Y. 1978); 17 CFR 202.5(c).

circumstances where it believes that prompt action is required (for example, enforcement actions where the Division of Enforcement intends to seek a temporary restraining order, preliminary injunction or some other form of emergent relief).

Wells Notices are generally given in writing and are often preceded by a telephone call. Legal counsel may have an opportunity to meet with staff who have conducted the investigation as well as with more senior officials at the Division of Enforcement to discuss their theory of the case, the evidence against the firm and their reasons for believing that a securities law violation has occurred in order to better understand the rationale for recommending an enforcement action. This can be helpful in preparing an effective Wells memorandum.

Wells Notices usually provide a time frame for a Wells submission and set out limitations on the submission's size (typically 40 pages for a written submission and 12 minutes for a videotaped submission).[37] A person or entity against whom a potential enforcement action is contemplated is not permitted to read the memorandum sent to the SEC recommending the commencement of an enforcement action. However, the staff conducting the investigation and senior officials at the Division of Enforcement will be able to review any Wells submission before making a final decision to recommend an enforcement action.

Wells submissions are sometimes successful in persuading the staff conducting the investigation, or more senior officials in the Enforcement Division, not to recommend an enforcement action but instead to close the investigation. However, if the division's staff persists in believing an enforcement action should be commenced, any Wells submissions will be submitted to the SEC along with the Enforcement Division's recommendation for an enforcement action or administrative proceeding. This allows the SEC to consider arguments against an enforcement action while at the same time considering a request to initiate an enforcement action.

There are many considerations that inform whether and how to make a Wells submission,[38] but an effective one may address the following:

- ***Legal and policy issues.*** The SEC has said that submissions may *"prove most useful"* when they address questions of policy surrounding whether a particular enforcement action should be brought.[39] For example, arguments that the staff is treating a case more aggressively than other similar cases or that an enforcement action against a cooperator may reduce (or 'chill') cooperation in future investigations may prove helpful.[40] The SEC may be receptive to arguments that the staff is pursuing

[37] SEC Enforcement Manual, *supra*, § 2.4, at 23–24.

[38] For example, a Wells submission may be discoverable in subsequent private litigation. See, *In re Steinhardt Partners, L.P.*, 9 F.3d 230, 236 (2d Cir. 1993).

[39] Commencement of Enforcement Proceedings and Termination of Staff Investigations, Securities Act Release 33-5310 (February 28, 1973).

[40] Mahoney, *supra*, at A-73.

novel legal theories that are unjustified by current law or that have been rejected by courts in similar circumstances.[41]

- *Facts.* Although the SEC has cautioned that it is not in a position to decide issues of fact in the Wells process,[42] a persuasive presentation of the relevant facts may prove helpful, especially if counsel can show that the staff is operating under an incomplete or misguided view of the facts.[43] Urging a different interpretation of emails and other documents, however, is not likely to be persuasive at the Wells stage. Moreover, one must take care when arguing facts because a submission made at a time when the facts are not fully developed could result in a factual summary that is either incomplete or wrong. Any inaccuracies are likely to be damaging in later proceedings.
- *Remedies sought.* The remedies available in enforcement actions and administrative proceedings are discussed further on page 23. In a Wells submission, an argument that the remedies sought are unjustified based on the facts or the law and/or are inconsistent with similar enforcement proceedings, may prove persuasive.[44]

After making a Wells submission, counsel can request a meeting with the staff that conducted the investigation or senior officials in the Enforcement Division to discuss it. Counsel may wish to inquire which portions of the submission were most helpful and may also offer to make supplemental submissions (either verbally or in writing) to clarify issues where uncertainty remains or to provide additional advocacy.

SEC approval of enforcement actions/administrative proceedings

SEC authorisation must be obtained to bring an enforcement action in a federal court or an administrative proceeding. To obtain approval, the Enforcement Division must submit a comprehensive 'action memorandum' detailing the factual and legal basis for the proposed action.[45]

The action memorandum must be approved by the Director or a Deputy Director of the Enforcement Division before it is sent to the SEC for consideration.[46] The SEC then decides whether to authorise the enforcement action, instruct that no action is to be taken or direct the Enforcement staff to gather additional facts.

The Enforcement staff may also seek, and the SEC may grant permission to begin settlement negotiations, but in certain cases (in accordance with SEC policy announced in June 2013[47]) a settlement may require an admission of wrongdoing in order to obtain SEC approval (all settlements require SEC approval before they can become

[41] Mahoney, *supra*, at A-73.
[42] Securities Act Release 33-5310, *supra*.
[43] Mahoney, *supra*, at A-73.
[44] Mahoney, *supra*, at A-74.
[45] SEC Enforcement Manual, *supra*, § 2.5.1.
[46] SEC Enforcement Manual, *supra*, § 2.5.1, at 25–26.
[47] See Dave Michaels, (June 19, 2013), *SEC Says It Will Seek Admission of Wrongdoing More Often*, Bloomberg.

effective). Four types of cases have been identified where the SEC would potentially require such admissions:[48]

1. A large number of investors were harmed or the conduct was otherwise egregious.
2. Conduct posed a significant risk to the market or investors.
3. Admissions would help investors decide whether to deal with a particular party in the future.
4. Reciting unambiguous facts would send an important message to the market about a particular case.

FOIA and confidentiality relating to investigations

The Freedom of Information Act (FOIA) requires federal agencies like the SEC to provide access to records on request from a member of the public, unless an exemption from disclosure applies.[49] This obligation extends to records provided to the SEC during investigations.[50] This means that records that a fund or individual produces to the SEC during an investigation may be subject to public disclosure, unless an exemption allows those records to remain confidential.[51]

Under the SEC rules, anyone providing documents, testimony or other information to the SEC may request confidential treatment (which is referred to as 'FOIA Confidentiality').[52] While this does not guarantee that records will remain confidential,[53] it at least ensures that the person requesting confidential treatment receives notice in the event there is a request for access to their records[54] and also gives that person ten days to 'substantiate' the claim of confidentiality.[55]

The SEC routinely denies FOIA requests for records relating to ongoing investigations or for any analysis, internal memoranda or other work product prepared by the staff in connection with its investigation, even if the investigation has been closed for a significant amount of time. Nonetheless, since the SEC's rules require confidential treatment to be requested when records are first produced,[56] the SEC presumes that

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[48] Mary Jo White, Chairperson, (September 26, 2013), *Securities and Exchange Commission, Deploying the Full Enforcement Arsenal*, Remarks Before the Council of Institutional Investors Fall Conference in Chicago, IL.

[49] See 5 USC § 552.

[50] See 15 USC § 78x(a).

[51] Examples of potentially applicable exemptions from disclosure include FOIA's exemptions for (i) *"trade secrets and commercial or financial information obtained from a person and privileged or confidential,"* (ii) *"personnel and medical files and similar files, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy,"* and (iii) records compiled *"for law enforcement purposes,"* the disclosure of which *"could reasonably be expected to interfere with enforcement proceedings."* 5 USC § 552(b)(4), (6), (7)(A).

[52] See 17 CFR § 200.83.

[53] 17 CFR § 200.83(a) (*"This section is procedural only and does not provide rights to any person or alter the rights of any person under the Freedom of Information Act or any other applicable statute or regulation."*).

[54] 17 CFR § 200.83(d) (1).

[55] 17 CFR § 200.83(d) (1)–(2).

[56] 17 CFR § 200.83(c) (1).

a failure to make such a request is an indication of a waiver of any interest in maintaining confidentiality.[57] Legal counsel should therefore carefully consider requesting confidential treatment of any sensitive materials supplied to the SEC at the time of their production.

Criminal investigations by the US Attorneys' Offices/DOJ

The SEC's jurisdiction only extends to civil violations. By contrast, the DOJ and the USAO may bring criminal charges for 'willful' violations of the same securities laws or under other federal statutes (such as those criminalising mail fraud, wire fraud and money laundering).[58] With regard to the DOJ's criminal investigations, the SEC can, and often does, discuss and share information with the DOJ,[59] and their investigations may be parallel.

Criminal investigative techniques

Grand juries

The DOJ can use a grand jury's subpoena power to compel the production of documents or testimony.[60] As grand jury proceedings generally must remain secret, the DOJ ordinarily cannot share such matters with the SEC.[61] Witnesses before the grand jury (unlike witnesses in SEC investigations) cannot have legal counsel present while testifying[62] although they may consult with their attorneys during breaks. Grand jury witnesses may assert the Fifth Amendment privilege against self-incrimination, the attorney-client privilege, or the work product doctrine, to the extent applicable.[63]

Wiretaps

Recently, the DOJ has begun to use wiretaps in investigating securities law violations, particularly in insider trading cases.[64]

Wiretaps require the approval of a federal judge. To obtain this, the government must submit an affidavit from a federal investigator[65] and establish that other investigative techniques *"have been tried and have failed or reasonably appear to be unlikely to succeed if tried or to be too dangerous."*[66]

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[57] 17 CFR § 200.83(h) (1).

[58] See 15 USC §§ 77x, 78ff (a), 80a-48, 80b-17.

[59] See, e.g., 15 USC § 78u (d)(1); 17 CFR 203.2; SEC Enforcement Manual, *supra*, §§ 5.1–5.2.

[60] *Kastigar v. United States*, 406 US 441, 443 (1972) (*"The power of government to compel persons to testify in court or before grand juries and other governmental agencies is firmly established in Anglo-American jurisprudence."*); see Fed. R. Crim. P. 17(c) (*"A subpoena may order the witness to produce any books, papers, documents, data, or other objects the subpoena designates."*).

[61] SEC Enforcement Manual, *supra*, § 5.2.2 (*"The SEC is generally not privy to grand jury matters."*); see Fed. R. Crim. P. 6(d)(1), (e)(2).

[62] See, e.g., *Wheel v. Robinson*, 34 F.3d 60, 67 (2d Cir. 1994).

[63] *Hoffman v. United States*, 341 US 479, 489–90 (1951) (Fifth Amendment privilege); *In re Green Grand Jury Proceedings*, 492 F.3d 976, 979 (8th Cir. 2007) (attorney-client and work product).

[64] See Insider Trading Law and Compliance, *supra*, at 535; Prepared Remarks for Preet Bharara, *US v. Rajaratnam*, et al; *US v. Danielle Chiesi*, et al. Hedge Fund Insider Trading Takedown (October 16, 2009), at: www.justice.gov/usao/nys/hedgefund/hedgefundinsidertradingremarks101609.pdf.

[65] See 18 USC § 2518(1)(b) (setting forth the required assertions that must be included in the affidavit).

[66] 18 USC § 2518(3)(c); see *United States v. Verdin-Garcia*, 516 F.3d 884, 889–90 (10th Cir. 2008).

The judge may authorise the wiretap for up to 30 days, but 30-day extensions can be obtained by showing the appropriate prerequisites.[67] In 2013, a federal court of appeals upheld the admission of wiretap evidence in the insider trading trial of Raj Rajaratnam, the founder of the Galleon group of hedge funds, in what was the first use of wiretaps in an insider trading case.[68]

Indictments

Grand juries also return criminal indictments (formal written pleadings setting out the charges and beginning the criminal case).[69]

To obtain an indictment, a prosecutor presents evidence to the grand jury, drafts the indictment and sends the draft indictment to the grand jury. The grand jury must then decide whether the evidence establishes 'probable cause' that the alleged crimes have been committed.[70] If the grand jury concludes that there is probable cause, it will return the indictment to a magistrate judge in open court and the criminal case begins.[71]

Defendants must be given fair notice of the charges against them and, in that regard, the indictment must set out the 'essential facts' of the alleged offences and cite the statutes or rules allegedly violated.[72]

In certain cases, an indictment may be sealed or kept secret from the public until the defendants are arrested and in custody.[73] This is to prevent the flight of a defendant before an arrest can take place. The prosecutor generally makes an informal oral motion or request to the magistrate judge to seal the indictment when the grand jury returns it.

FCA investigations and enforcement

Investigations

FCA investigations can begin informally with the agency making voluntary requests for information. Even in informal investigations, the FCA has wide latitude in the categories of information it seeks, although it has indicated that generally it will not ask for the voluntary production of documents that could not otherwise be obtained through compulsory process.[74]

If after informally gathering information, the FCA decides further investigation is warranted, it may appoint investigators to conduct an inquiry. The appointment of investigators

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[67] 18 USC § 2518(5).
[68] *United States v. Rajaratnam*, 719 F.3d 139 (2d Cir. 2013), *cert. denied*, No. 13-1001, 2014 WL 675364 (US June 16, 2014).
[69] See Gordon Mehler et al., *Federal Criminal Practice: A Second Circuit Handbook* 445 (13th ed. 2013).
[70] See *United States v. Romano*, 706 F.2d 370, 374 (2d Cir. 1983).
[71] See Fed. R. Crim. P. 6(f).
[72] Fed. R. Crim. P. 7(c) (1).
[73] See Fed. R. Crim. P. 6(e) (4).
[74] See Linklaters, Regulatory Investigations – Introduction, at 2 (Linklaters) at: www.linklaters.com/pdfs/mkt/london/Regulatory_Investigations_Introduction.pdf.

formally begins the investigative process.[75] The FCA may appoint investigators if it finds 'good reason' or if there is reason to suspect that a regulatory breach, offence, money laundering or market abuse has occurred.[76] Generally, the FCA sends the defendant firm a Notice of Appointment of Investigators, which is usually non-public.[77] However, in certain cases (for example, those involving insider dealing or market abuse), the subjects of the investigation do not need to be notified at the outset. This may be because the FCA does not yet know the identities of all the relevant parties.[78]

The following information-gathering techniques can be employed by the FCA during an investigation:

- *Requests for information.* Formal requests for information or documents generally are made in writing. The FCA may also send an officer to collect the information or documents. In that instance, the information must be provided 'without delay.'[79] The FCA is empowered to gather any information 'reasonably required' in the exercise of its regulatory authority.[80]
- *Search warrants.* The FCA has the power to enter and search premises by force through search warrants.[81] Search warrants are generally executed after hours since firms are required to allow the FCA to enter their premises during normal business hours, even if the FCA has not provided prior notice.[82] In executing a search warrant, the FCA can require that documents be produced and turned over and can question anyone on the premises about those documents.[83]
- *Interviews.* Relevant persons in the investigation can also be interviewed by the FCA. Interviewees may have their legal advisers present, but may not invoke the privilege against self-incrimination. Interviews are generally recorded and the interviewee is given a copy of the transcript.[84]
- *Skilled person reports.* These reports are created by someone appointed by either the firm under investigation or the FCA itself and can cover any matter 'reasonably required' in connection with the FCA's exercise of its statutory functions.[85] In some cases, firms may wish to have someone produce a parallel report if the firm anticipates issues with the FCA's appointed person's report.[86]

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[75] Linklaters, *supra*, at 25.
[76] Financial Services and Markets Act, 2000, c. 8 §§ 167(1), 168.
[77] See Fin Conduct Auth., Enforcement Information Guide, at 2–3 (April 2013) at: www.fca.org.uk/static/documents/enforcement-information-guide.pdf (FCA, Enforcement).
[78] Linklaters, *supra*, at 25.
[79] Financial Services and Markets Act, 2000, c. 8 § 165(1), (3); see Linklaters, *supra*, at 5.
[80] Financial Services and Markets Act, 2000, c. 8 § 165(4).
[81] See Financial Services and Markets Act, 2000, c. 8 § 176.
[82] Linklaters, *supra*, at 10.
[83] Financial Services and Markets Act, 2000, c. 8 § 176(5).
[84] Linklaters, *supra*, at 29–30.
[85] Linklaters, *supra*, at 18–19; see Financial Services and Markets Act, 2000, c. 8 § 165, 166(1).
[86] Linklaters, *supra*, at 19.

When the investigative work is complete, the case is reviewed by an internal lawyer not involved in the investigation and the FCA issues a Preliminary Investigation Report (PIR).[87] The subject of the investigation has 28 days to respond to it and may request extra time if necessary.[88]

Enforcement

If the FCA believes enforcement action is warranted, it submits a final Investigative Report to the FCA's Regulatory Decisions Committee (RDC). If the RDC agrees the case is appropriate, it issues a Warning Notice informing the person that the FCA intends to take further action.[89] The FCA, after consulting with the person, may make the Warning Notice public.[90] After receiving the Warning Notice, the person may make a presentation, either written or oral, to the RDC. The RDC then issues a decision, which the person may appeal to the Upper Tribunal (Tax and Chancery Chamber), which examines the case 'afresh'.[91]

Types of enforcement actions

The SEC and DOJ focus their investigative and enforcement powers on various types of conduct and their priorities shift as the securities markets, and conduct in those markets, change and develop. Indeed, the securities laws contain several general anti-fraud provisions, which have broad application. This gives regulators and prosecutors the flexibility needed to protect the integrity of the securities markets and securities industry. This section looks at some of the areas relevant to private funds that have drawn the attention of the SEC and/or DOJ in recent years.

Insider trading

Insider trading is a high priority area for the SEC. In fiscal year 2012, the SEC brought 58 insider trading actions against 131 individuals and entities.[92] In fiscal year 2013, the SEC brought 43 insider trading actions against 94 defendants, representing approximately 20 percent of its total cases brought during that time.[93]

On the criminal front, the DOJ has been particularly aggressive in prosecuting insider trading. The US Attorney's Office for the Southern District of New York has engaged in a well-publicised effort to prosecute insider trading, bringing charges against more than 81 individuals since 2009.[94]

There is no securities law statute that precisely defines insider trading. Rather, such cases are brought under the authority of general anti-fraud provisions contained in

[87] FCA, Enforcement, *supra*, at 3.
[88] FCA, Enforcement, *supra*, at 3.
[89] FCA, Enforcement, *supra*, at 3.
[90] FCA, Enforcement, *supra*, at 3.
[91] FCA, Enforcement, *supra*, at 3.
[92] *SEC Enforcement Actions: Insider Trading Cases*, US Securities and Exchange Commission at: www.sec.gov/spotlight/insidertrading/cases.shtml.
[93] Securities and Exchange Commission, Select SEC and Market Data Fiscal 2013, at 3 (2013).
[94] See Insider Trading Law and Compliance, *supra*, at 528.

Section 10(b) of the Securities Exchange Act of 1934[95] and Rule 10b-5.[96] As a result, the law of insider trading has evolved predominantly through case law.[97]

The application of insider trading laws is not black and white. Generally, a person who is aware of material non-public information (meaning information a reasonable investor would consider important in making an investment decision and that has not been broadly disseminated and digested in the marketplace) may not trade if the person owes a duty of trust or confidence to the source of the information or is the recipient of a tip from someone who owes such a duty.[98] Such a duty may exist, for instance, between a corporate officer and the company and its shareholders or between parties that have entered into a confidentiality agreement (written or verbal) or that have a history of sharing confidences.[99]

In the tipper/tippee context, insider trading liability may be found where the tippee knew, or should have known, that a tipper breached a duty and where the tipper received a benefit from tipping.[100] In December 2014, the US Court of Appeals for the Second Circuit held that to sustain insider trading charges against a tippee, the government must prove that the tippee knew that the tipper disclosed the information in breach of a duty of trust and confidence in order to receive a personal benefit and that the benefit must be objective and consequential. [101]

Private funds and fund advisers facing pressure to show impressive returns may be tempted to use their relationships and connections to gain an informational advantage over the market. While some advantages represent good research and are permissible, others, such as those that make use of material, non-public information gained in breach of a duty of trust or confidence, do not. Trading on such information, depending on the particular facts and circumstances, could result in SEC or DOJ investigations and civil or criminal actions.

If there is any question about the lawfulness of trading on particular information, funds should consider how their actions will look to the authorities in hindsight and consult

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[95] 15 USC § 78j(b).

[96] 17 CFR § 240.10b-5. The SEC has also adopted a few rules relating to some of the specific elements of an insider trading violation. See 17 CFR § 240.10b5-1 (defining 'on the basis of' material non-public information as awareness of that information and providing certain safe harbors); 17 CFR § 240.10b5-2 (providing a 'non-exclusive definition' of circumstances creating a duty of trust or confidence for purposes of the misappropriation theory of insider trading liability).

[97] See Insider Trading Law and Compliance, *supra*, chs. 1–3 (discussing the development and elements of insider trading liability).

[98] See Insider Trading Law and Compliance, *supra*, at 2–3.

[99] See Insider Trading Law and Compliance, *supra*, ch. 9.

[100] See Insider Trading Law and Compliance, *supra*, ch. 10 (discussing tipper/tippee liability).

[101] See *United States v. Newman*, 2014 WL 6911278 (2d Cir. December 10, 2014). Courts and the SEC previously had been willing to assume a personal benefit unless the tippee proved otherwise. See, for example, *SEC v. Rubin*, No. 91 Civ. 6531, 1993 WL 405428, at *5 (S.D.N.Y. October 8, 1993); Insider Trading Law and Compliance, *supra*, at 249.

experienced legal counsel on the matter. Moreover, funds should have in place policies and procedures designed to minimise the potential for insider trading before it occurs.[102] Case study 1 on page 28 looks at how the use of expert networks has resulted in insider trading cases and discusses some of the things funds can do to minimise the risks associated with such networks.

Ponzi schemes

In a Ponzi scheme, instead of investing the money contributed by investors as promised, the scheme operators use some of the funds from new investors to pay 'returns' to existing investors in order to create the appearance of robust investment performance and to attract new investors while stealing the rest of the money that was supposed to be invested for the benefit of the investor.[103]

Since 2010, the SEC has brought more than 100 enforcement actions against nearly 200 individuals and 250 entities for carrying out Ponzi schemes.[104] In the first nine months of 2013, the SEC brought 23 cases relating to alleged Ponzi scheme activity;[105] that is approximately 7 percent of all the cases brought by the SEC in that time frame.[106] Like insider trading, Ponzi schemes are likely to result in referrals to, and coordination with, criminal prosecutors.

Market manipulation

Market manipulation involves artificially affecting the market and can be in the form of fraudulent pump-and-dump schemes (artificially increasing the price of a security and then dumping it on the market at a profit), wash sales used to create the appearance of robust trading volume, or more technical violations of the provisions of the SEC's Regulation M (in particular Rule 105 of Regulation M).[107] Market manipulators may also face criminal charges.

In March 2013, both the SEC and DOJ brought charges against a CEO who offered to pay kickbacks to an individual for orchestrating the purchase of hundreds of thousands of shares in his company's stock.[108] Also in March 2013, the FBI arranged for the arrest of a German hedge fund manager in Italy in connection with a market manipulation

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[102] See Insider Trading Law and Compliance, *supra*, ch. 22 (discussing policies, procedures, and testing designed to prevent insider trading).

[103] See *Ponzi Schemes*, US Sec. and Exchange Commission, http://www.sec.gov/answers/ponzi.htm

[104] *SEC Enforcement Actions: SEC Enforcement Actions Against Ponzi Schemes*, US Securities and Exchange Commission at: www.sec.gov/spotlight/enf-actions-ponzi.shtml.

[105] Morvillo, Abramowitz, Grand, Iason & Anello PC, *SEC Enforcement Data and Analysis*, at 2 (2013) (Morvillo, SEC Enforcement Data).

[106] Morvillo, SEC Enforcement Data, *supra*, at 2.

[107] See Daniel J. Kramer, Marc. E. Elovitz & William H. Gussman, *Regulation of Market Manipulation*, in 2 Federal Securities Exchange Act of 1934, ch. 6, § 6.03[4] (Matthew Bender, rev. ed., 2013) (describing various types of prohibited market manipulation).

[108] *SEC Charges Falcon Ridge Development, Inc. and Its President and CEO for Market Manipulation Scheme*, Litig. Rel. No. 22630 (March 1, 2013) at: www.sec.gov/litigation/litreleases/2013/lr22630.htm.

scheme involving his Cayman Islands-based hedge funds.[109] The manager allegedly purchased billions of shares of illiquid penny stocks and then 'cross-traded' them among his funds in order to pump up the price and inflate his management fees.[110] The fraud resulted in over $200 million in losses to investors according to prosecutors.[111]

On the more technical side, Regulation M consists of a series of rules designed to prevent manipulative trading by persons with an interest in an offering of securities.[112] Rule 105 prohibits buying shares in a firm commitment equity offering if the would-be purchaser sold shares of that stock short within a specified period before pricing of the offering (unless the trader fits into one of the exceptions to the Rule).[113] The point of the rule is to prevent people from using short sales to manipulate the price of the stock downward in the hope of obtaining the stock at a lower price in the offering. Since stock offerings are generally priced at a discount to the previous day's closing price, aggressive short selling before pricing could result in a lower offering price and less money to the issuer. Rule 105 seeks to avoid that artificial result and to ensure that offering prices are based on the natural forces of supply and demand.[114]

The SEC considers a Rule 105 violation to be a strict liability offence,[115] so the intent of the trader is irrelevant. However, there are three exceptions to Rule 105, which permit the purchase of shares in the offering despite a short sale during the restricted period.[116]

Between January 2010 and September 2013, the SEC settled over 40 actions alleging Rule 105 violations, collecting over $42 million in disgorgement, penalties and interest in those settlements.[117] On September 17, 2013, the SEC charged 23 firms, including many hedge funds, with Rule 105 violations.[118] That same day, OCIE issued a Risk Alert stressing the importance of having effective policies and procedures to comply with Rule 105.[119]

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[109] *Fugitive Hedge Fund Manager Arrested in Italy in US Case Alleging Market Manipulation Scam that Led to at Least $200 Million in Losses*, Fed. Bureau of Investigation (March 8, 2013) at: www.fbi.gov/losangeles/press-releases/2013/fugitive-hedge-fund-manager-arrested-in-italy-in-u.s.-case-alleging-market-manipulation-scam-that-led-to-at-least-200-million-in-losses (Fugitive Hedge Fund Manager).

[110] See Fugitive Hedge Fund Manager, *supra*.

[111] See Fugitive Hedge Fund Manager, *supra*.

[112] See 17 CFR §§ 242.100–242.105; Kramer, Elovitz, & Gussman, *supra*, § 6.03[5][a]-[b] (discussing the rules under Regulation M).

[113] 17 CFR § 242.105(a).

[114] See Office of Compliance Inspections and Examinations, Rule 105 of Regulation M: Short Selling in Connection with a Public Offering, at 1–2 (September 17, 2013), at: www.sec.gov/about/offices/ocie/risk-alert-091713-rule105-regm.pdf (OCIE, Rule 105).

[115] OCIE, Rule 105, *supra*, at 3.

[116] See 17 CFR § 242.105(b).

[117] OCIE, Rule 105, *supra*, at 1.

[118] Press Release, Securities and Exchange Commission, SEC Charges 23 Firms With Short Selling Violations in Crackdown on Potential Manipulation in Advance of Stock Offerings (September 17, 2013) at: www.sec.gov/News/PressRelease/Detail/PressRelease/1370539804376.

[119] OCIE, Rule 105, *supra*, at 1.

Misappropriation of investor funds

The SEC is careful to investigate instances where fund managers may have misappropriated fund assets. For example, in March 2011, the SEC charged a hedge fund manager with misappropriating over $12 million in investment gains generated in a 'side pocket' in one of his funds.[120] According to the SEC, since the side pocket offered limited visibility to investors, the manager was able to conceal the gains and divert them to other entities he controlled, including a real estate venture. The manager paid over $14 million to settle the charges. In May 2013, another hedge fund manager settled charges that it misappropriated over $2.65 million of fund assets to prop up an electrical contracting company the manager controlled and which eventually filed for bankruptcy.[121]

The SEC also has a focus on instances where a fund may use investor assets for purposes not permitted under the fund documents. For example, in *SEC v. Gruss*, the SEC brought charges against the former chief financial officer of D.B. Zwirn & Co., L.P. for allegedly making more than $870 million in unauthorised cash transfers.[122] Gruss allegedly transferred cash between different investment funds in order to cover cash shortages, even though such transfers were not permitted by the relevant offering documents or management agreements nor disclosed to investors until much later.[123] He also allegedly caused an undocumented loan of $3.8 million of fund assets to finance the purchase of a private plane; that loan was repaid without interest.[124] Finally, Gruss allegedly caused the funds to pay management fees before they were due. It is worth noting that the SEC did *not* bring an enforcement action against the hedge fund manager/investment advisory firm, crediting the firm's self-reporting of Gruss's misconduct and its cooperation in the SEC investigation.

Trade allocations

Trades must be allocated equitably among different accounts. Advisers managing multiple funds can run into trouble if they allocate profitable trades to certain accounts at the expense of other less favored accounts. Advisers may be tempted, for example, to allocate profitable trades to accounts paying higher performance-based fees in order to give those fees a boost, but doing so can lead to SEC investigations and enforcement actions.

In December 2012, for instance, the SEC brought an action in federal court against Peter J. Eichler, Jr., a California-based investment adviser and his firm for engaging in a 'cherry-picking' scheme in which Eichler allegedly allocated winning trades to his personal account as well as to certain accounts of his employees and select client accounts, while allocating losing trades to the accounts of two hedge funds his firm

[120] Press Release, Sec. and Exchange Commission, SEC Charges Bay Area Hedge Fund Manager With Misappropriating 'Side Pocketed' Assets (March 1, 2011) at: www.sec.gov/news/press/2011/2011-54.htm.

[121] In the Matter of *Walter v. Gerasimowicz*, Securities Act Release No. 9401, 2 (May 3, 2013).

[122] Complaint 2, *SEC v. Gruss*, 11 Civ. 2420 (S.D.N.Y. April 8, 2011).

[123] Complaint 3–4, *Gruss*, 11 Civ. 2420.

[124] Complaint 38–47, *Gruss*, 11 Civ. 2420; see also *SEC v. Gruss*, 859 F. Supp. 2d 653 (S.D.N.Y. 2012) (denying motion to dismiss).

managed.[125] In October 2013, the SEC obtained judgements against two Illinois-based investment advisers based on a similar cherry-picking scheme.[126]

Asset valuations

Particularly for funds that trade in illiquid or complex investments, asset valuation issues have also become an area of focus for the SEC. The concern is that funds may lack adequate procedures and methodologies to consistently and fairly value their assets or, despite having adequate procedures and methodologies, funds may fail to follow them. The result of such shortcomings may be improperly inflated asset values and fees.

The SEC has brought a number of enforcement actions/administrative proceedings alleging violations based on improper valuations. In 2012, a New Jersey-based investment manager was sued for allegedly fraudulently overvaluing investments in convertible securities in order to increase its fees and *"mask the risky and illiquid nature of its investment strategy."*[127] In June 2013, the SEC settled charges with eight mutual fund directors for failing to adequately exercise their responsibility to assess the 'fair value' of below investment-grade subprime mortgage-backed securities.[128] The SEC found that the directors delegated this responsibility to a special committee but failed to provide the committee with guidance on how to assess fair value and then failed to inform themselves of how the determinations were being made.[129]

Even where the ultimate value of the assets is not at issue, the SEC often focuses attention on firms that either do not have adequate valuation procedures or fail to follow their valuation processes, as the administrative proceeding against Quantek Asset Management discussed in detail in Case study 2 at page 30, demonstrates.

Marketing and performance data

SEC officials have suggested that the 'retailisation' of hedge funds and increasing competition among funds warrant focusing enforcement staff's attention on funds' marketing practices and use of performance data.[130] Since funds need to show performance metrics to attract new investors and keep existing investors satisfied, managers may face a temptation to push the limits of how the fund's strategy and performance history are marketed.

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[125] *SEC Charges Santa Monica-Based Hedge Fund Manager in Cherry-Picking Scheme*, Litig. Release No. 22573, US Securities and Exchange Commission (December 14, 2012) at:www.sec.gov/litigation/litreleases/2012/lr22573.htm.

[126] *SEC Obtains Judgments By Consent Against Charles J. Dushek, Charles S. Dushek, and Capital Management Associates, Inc.*, Litig. Release No. 22840, US Sec. and Exchange Commission (October 10, 2013) at: www.sec.gov/litigation/litreleases/2013/lr22840.htm.

[127] *SEC v. Yorkville Advisors, LLC*, No. 12 Civ. 7728, 2013 WL 3989054, at *1 (S.D.N.Y. August 2, 2013).

[128] In the matter of J. Kenneth Alderman, CPA, Investment Company Act Release No. 30557 (June 13, 2013).

[129] In the matter of J. Kenneth Alderman, CPA, Investment Company Act Release No. 30557, 1.

[130] See Bruce Karpati, Chief, Asset Management Unit of SEC's Division of Enforcement, Enforcement Priorities in the Alternative Space (December 18, 2012) (Karpati Speech).

In late 2011, the SEC's Asset Management Unit, which deals in large part with hedge funds and private equity funds, announced an Aberrational Performance Inquiry focusing on 'suspicious or improbable returns' generated by hedge fund managers, including investigations of potentially fraudulent marketing and performance advertising practices.[131] OCIE has also identified marketing and performance advertising as a priority for compliance examinations.[132]

Extraterritorial application of US securities law/ cooperation with foreign authorities

As global financial markets become more intertwined and the private fund industry expands internationally, the extraterritorial reach of US securities laws and the cooperation between US authorities and their foreign counterparts are likely to have a meaningful impact on global enforcement of securities law norms. This section looks at those issues in the context of SEC and DOJ actions.

Extraterritorial application

Before 2010, the application of US securities laws to transnational securities fraud depended on the extent of the conduct occurring in the US and/or the effects of that conduct in the US.[133] Courts applied these 'conduct and effects' tests using a variety of approaches, but the tests were generally satisfied (and the federal securities laws applied) where, for instance:

- The 'mastermind' of the fraud operated in the US, even if the securities were sold abroad.
- Significant efforts relating to the fraud, such as drafting misleading prospectuses or accounting work reflected in misleading financial statements, occurred in the US.
- The fraud caused direct injury to investors resident in the US.[134]

However, in 2010, the US Supreme Court rejected the 'conduct and effects' tests for private securities actions in *Morrison v. National Australia Bank Ltd*.[135] There the Court restricted the application of section 10(b) of the Exchange Act to fraud in connection with *"the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States."*[136] In doing so, the Court emphasised that US securities laws do not provide a private right of action for so called 'foreign cubed' transactions (transactions where the plaintiff allegedly defrauded is a non-US person, the security is not traded on a US exchange, and the trade was effected overseas).

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[131] See Karpati Speech, *supra* (discussing the Aberrational Performance Inquiry).
[132] Karpati Speech, *supra*; OCIE, Examination Priorities, *supra*, at 4.
[133] See *Morrison v. Nat'l Austl. Bank Ltd.*, 130 S. Ct. 2869, 2879–80 (2010).
[134] See Staff of the SEC, Study on the Cross-Border Scope of the Private Right of Action Under Section 10(b) of the Securities Exchange Act of 1934, at ii (April 2012); Harry Davis & Megan Elizabeth Zavieh, 'Uncle Sam is Watching You', *Hedge Funds Review*, March 2006, at 32, 32–34.
[135] 130 S. Ct. 2869 (2010).
[136] Morrison, 130 S. Ct. at 2888.

Following *Morrison*, a number of lower courts dismissed claims brought by the SEC for failing to satisfy *Morrison*'s transactional test.[137] Congress responded to *Morrison* by enacting section 929P(b) of Dodd-Frank, which restored the conduct and effects tests but only for actions brought by the SEC and/or DOJ/USAO.[138]

Cooperation with foreign authorities

The SEC has stressed the importance of coordinating with financial regulators in other countries, especially in light of the global financial crisis of 2008–2009, which demonstrated the close interconnection between global financial markets.[139] The SEC regularly shares information with foreign financial regulators, generally through Memoranda of Understanding (MOUs) with foreign regulators, and assists in obtaining information in the US for use by foreign regulators in their investigations.

Types of cooperation

Sharing information

The SEC has authority to provide its non-public records to foreign securities regulators.[140] To get those records, the foreign regulator must agree to keep the information confidential and notify the SEC of any demands for disclosure of that information.[141] The SEC responded to 508 requests for information from foreign regulators in fiscal year 2013.[142]

The SEC also actively seeks information *from* its foreign counterparts, making hundreds of these requests each year[143] and frequently acknowledging their assistance in conducting investigations.[144] In 2011, for example, the SEC worked with the Cayman Islands Monetary Authority and the Financial Market Authority Liechtenstein to bring charges against the managers of a Cayman hedge fund for misappropriating fund assets.[145]

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[137] See *SEC v. Benger*, No. 09 C. 676, 2013 WL 593952, at *10, *13 (N.D. Ill. February 15, 2013); *SEC v. Tourre*, 790 F. Supp. 2d 147, 156–61, 163–64 (S.D.N.Y. 2011).

[138] See Dodd-Frank Act § 929P(b) (adding an extraterritorial jurisdiction provision to 15 USC § 77v(a), 15 USC § 78aa, and 15 USC § 80b-14).

[139] *Office of International Affairs*, US Securities and Exchange Commission at: www.sec.gov/about/offices/oia.shtml.

[140] 15 USC 78x(c); 17 CFR § 240.24c-1.

[141] See 17 CFR § 240.24c-1(b); *International Enforcement Assistance*, US Securities and Exchange Commission, at: www.sec.gov/about/offices/oia/oia_crossborder.shtml (*International Enforcement Assistance*).

[142] US Securities and Exchange Commission, Fiscal Year 2013 Agency Financial Report, at 22 (2013) at: www.sec.gov/about/secpar/secafr2013.pdf .

[143] US Securities and Exchange Commission, Fiscal Year 2013 Agency Financial Report, at 22 (717 requests for information from foreign regulators in fiscal year 2013); *International Enforcement Assistance*, *supra* (772 requests in fiscal year 2011).

[144] See *International Enforcement Assistance*, *supra* (listing examples of cooperation with foreign regulators).

[145] Press Release, US Securities and Exchange Commission, *Securities and Exchange Commission v. Juno Mother Earth Asset Management, LLC*, Eugenio Verzili and Arturo Allan Rodriguez Lopez a/k/a Arturo Rodriguez, Defendants, Civ. No. 11-CV 1778 (S.D.N.Y.) (TPG), Litig. Release No. 21886 (March 15, 2011).

Conducting investigations

The SEC may conduct investigations in the US on behalf of foreign regulators.[146] This includes the power to issue subpoenas for documents and testimony, even if the conduct at issue would not violate US law.[147] In determining whether to conduct such an investigation, the SEC considers whether the foreign authority would provide reciprocal assistance and whether the investigation would prejudice the public interest of the US.[148]

Mechanisms for cooperation

The SEC and foreign regulators share information using a number of mechanisms, including:

- ***Multilateral Memorandum of Understanding (MMOU).*** The MMOU sets out the intent of the signatories regarding the sharing of information related to securities enforcement. It provides that signatories will share certain information, permit its use in enforcement proceedings and otherwise keep it confidential.[149] The SEC credits the MMOU with 'significantly enhancing' its enforcement programme by allowing for the expeditious gathering of information from a number of jurisdictions.[150] As of 2012, the MMOU had been signed by 80 securities and derivatives regulators.[151]
- ***Bilateral Memoranda of Understanding.*** The SEC also shares information with foreign authorities under bilateral MOUs with more than 20 countries[152] and enters into new bilateral MOUs if they supplement or enhance the obligations set forth in the MMOU.[153]
- ***Mutual Legal Assistance Treaties (MLAT).*** These are administered by the DOJ and are generally used to exchange information about criminal matters. In certain cases, particularly those in which the US has a criminal interest, the SEC may be able to obtain information by relying on an MLAT. The SEC has indicated that MLATs may be especially useful if a jurisdiction does not have an MOU with the SEC or an MOU does not provide for the type of information gathering the SEC desires.[154]
- ***Ad hoc measures.*** The SEC will use such measures to gather information from foreign authorities when a foreign jurisdiction is not a signatory to an MOU with the SEC.[155]

Enforcement remedies

The remedies available to the SEC and DOJ/USAO for violations of the securities laws are varied and serious. The SEC can seek, for instance, preliminary and permanent

[146] 15 USC § 78u(a)(2).
[147] 15 USC § 78u(a)(2).
[148] 15 USC § 78u(a)(2); *International Enforcement Assistance*, *supra*.
[149] MMOU, *supra*, §§ 7, 10–11.
[150] *International Enforcement Assistance*, *supra*.
[151] *International Enforcement Assistance*, *supra*.
[152] *International Enforcement Assistance*, *supra*.
[153] *International Enforcement Assistance*, *supra*.
[154] SEC Enforcement Manual, *supra*, § 3.3.6.3, at 79.
[155] *International Enforcement Assistance*, *supra*.

injunctions, disgorgement of ill-gotten gains (or losses avoided) and monetary penalties, while the DOJ/USAO can seek imprisonment, fines and restitution to victims of a crime. On top of the direct penalties sought by these authorities, enforcement actions may have collateral consequences, which are discussed below.

Remedies available to the SEC

The SEC can bring proceedings either in federal court or before an administrative law judge. As discussed in this section, the remedies available in each type of proceeding, though similar, are not identical.

Judicial remedies

Judicial remedies include:

- ***Injunctions.*** This is the principal judicial remedy sought by the SEC to stop wrongdoing and prevent future misconduct by the person or entity, and generally requires the defendant to cease certain activities and to 'obey the law.'[156] The SEC routinely obtains these types of injunctions, but courts have been careful to point out the seriousness of injunctive relief, describing it as a "drastic remedy" that is not appropriate for all violations.[157]

  Injunctions are not designed to punish past violations of the securities laws. Instead, they are designed to stop ongoing violations and to prevent future violations.[158] For that reason, courts require the SEC to demonstrate a 'reasonable likelihood' of future violations in order to obtain a permanent injunction.[159] Past violations are nevertheless a factor courts can consider, along with the egregiousness of the violation, whether the violation is intentional, the isolated or recurrent nature of the conduct, the defendant's recognition of his or her wrongdoing and the opportunities the defendant may have to repeat that wrongdoing in the future.[160] Once granted, injunctions are typically permanent, unless modified or dissolved by the court. Violating an injunction can lead to proceedings for contempt of court.
- ***Disgorgement.*** The SEC may seek disgorgement of a defendant's profits (or avoided losses) resulting from securities law violations. This is not designed to compensate harmed investors,[161] but the SEC often seeks to use the disgorged funds (and sometimes the civil penalties, discussed below[162]) to repay the victims of the violations. The

[156] See *SEC v. Smyth*, 420 F.3d 1225, 1233 n.14 (11th Cir. 2005) (describing – and calling into question – the practice of issuing 'obey the law' injunctions).

[157] See *SEC v. Steadman*, 967 F.2d 636, 648 (D.C. Cir. 1992) (*"A permanent injunction is 'a drastic remedy' and should not be granted lightly, especially when the conduct has ceased."*); *SEC v. Haswell*, 654 F.2d 698, 700 (10th Cir. 1981) (*"An injunction is a drastic remedy, not a mild prophylactic, and should not be obtained against one acting in good faith."* (quoting *SEC v. Aaron*, 446 US 680, 703 (1980) (Burger, C.J., concurring))).

[158] *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1169 (D.C. Cir. 1978).

[159] See, e.g., *SEC v. Calvo*, 378 F.3d 1211, 1216 (11th Cir. 2004).

[160] See, e.g., *SEC v. Blatt*, 583 F.2d 1325, 1334 n.29 (5th Cir. 1978).

[161] See *SEC v. Blavin*, 760 F.2d 706, 713 (6th Cir. 1985).

[162] Matthew R. King et al., *Securities Fraud*, 46 Am. Crim. L. Rev. 1027, 1085 (2009); see 15 USC § 7246(a) (permitting the SEC to use civil penalties to compensate victims of fraud).

amount of disgorgement depends on the profits gained or losses avoided as a result of the violation and need only be a reasonable approximation of that amount.[163]

- *Civil monetary penalties.* There are three tiers of penalties available for violations (except for insider trading violations, which, as discussed below, are governed by their own statute). First-tier penalties may be imposed for violations that do not involve fraud. Second- and third-tier penalties are imposed for violations involving 'fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement', with third-tier penalties reserved for violations that also result in substantial losses or create a 'significant risk' of substantial losses to another person.[164]

  The three tiers are divided based on the nature and extent of the defendant's wrongdoing and are limited to the greater of a statutorily set amount ($5,000, $50,000, or $100,000 for a natural person or $50,000, $250,000, or $500,000 for entities) or the 'gross amount of pecuniary gain or loss avoided' resulting from the violation.[165]

  The specific statute governing civil penalties for insider trading provides for penalties as high as three times the profit gained or loss avoided as a result of the unlawful trading.[166]
- *Director and officer bars.* Courts may bar individuals who violate certain anti-fraud provisions of the securities laws from serving as directors and officers of public companies, provided that the individual's conduct demonstrates an 'unfitness' to serve as an officer or director.[167] Moreover, and of particular relevance to private investment funds, the SEC has the power to bar securities law violators from association with investment advisers and other registered securities firms (see 'Censures, bars and other non-monetary sanctions against securities professionals' below).
- *Ancillary relief.* Courts have broad discretion to fashion relief based on the circumstances of each particular case. This could include, for instance, the appointment of a receiver or the retention of an independent consultant to review policies and procedures.[168] Often, ancillary measures are negotiated and agreed in settlement negotiations between the SEC and the defendant.

Administrative remedies

Administrative remedies can be sought either before an administrative law judge or before the SEC itself. Such remedies may only be imposed after notice and opportunity for a hearing is provided to the respondent (except for temporary cease and desist orders, which may be imposed without notice to the respondent, and a hearing, if it would be impracticable or contrary to the public interest).[169] Many of

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[163] *SEC v. Warde*, 151 F.3d 42, 50 (2d Cir. 1998).
[164] 15 USC § 78u(d)(3)(B).
[165] 15 USC §§ 77t(d)(2), 78u(d)(3)(B), 80a-41(e)(2), 80b-9(e)(2).
[166] 15 USC § 78u-1(a)(2).
[167] 15 USC §§ 77t(e), 78u(d)(2).
[168] *SEC v. Amer. Bd. of Trade, Inc.*, 830 F.2d 431, 436 (2d Cir. 1987); *SEC Settles Its Claims Against Defendant Schottenfeld Group, LLC*, SEC Litig. Release No. 21,493, US Sec. and Exchange Commission (April 20, 2010) at: www.sec.gov/litigation/litreleases/2010/lr21493.htm (noting that a settlement with a broker-dealer in the Galleon case included the retention of an independent consultant to review the firm's 'enhanced' policies to prevent illegal conduct).
[169] See, e.g., 15 USC § 77h-1(a), (c)(1).

the administrative remedies available to the SEC are similar to those available in federal court.

- *Cease and desist orders.* These direct a person or entity to stop violating securities laws and prohibit future violations.[170] The order may demand that remedial steps be taken to avoid future infractions. If an order itself is infringed, the SEC may seek monetary penalties in federal court.[171]
- *Disgorgement.* Disgorgement, as well as an order for an accounting, is also available to the SEC in administrative proceedings.[172]
- *Monetary penalties.* Monetary penalties in administrative proceedings are similar but not identical to those available in federal court. Administrative monetary penalties are based on the same three-tier system as judicial penalties, but the amounts are capped at a statutorily set sum, rather than at the greater of a set sum or the pecuniary gain resulting from the violation.[173] Dodd-Frank amended various provisions of the securities laws to permit administrative penalties to be assessed against *any* person rather than only against regulated entities and associated persons, as had been the case prior to its passage.
- *Censures, bars, and other non-monetary sanctions against securities professionals.* Non-monetary sanctions can also be imposed against securities professionals, some of which can limit their ability to work in the securities industry. These sanctions include:
  - censure,
  - suspension for up to 12 months,
  - limitations on activities, or
  - a bar from being associated with an investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or rating organisation.[174]

  To impose these sanctions, the SEC must find, after notice and an opportunity for a hearing is given to the respondent, that the sanction is in the 'public interest' and that the person has engaged in certain conduct or is subject to certain kinds of court or administrative orders.[175] To illustrate, the SEC may censure, suspend or bar a person convicted of a felony or who 'willfully' violated the securities laws.[176] 'Willfully' in this context means "intentionally committing the act which constitutes the violation".[177] It does not mean that the person must have been aware that he or she was breaking the law.[178] For that reason, most violations will be found to be willful. On the spectrum of non-monetary sanctions, censure is the least severe and may be imposed in cases of minor wrongdoing or for violations of newly announced SEC policies where more

[170] 15 USC §§ 77h-1(a), 78u-3(a), 80a-9(f)(1), 80b-3(k)(1).
[171] 15 USC §§ 77t(d)(1), 78u(d)(3)(A), 80a-41(e)(1), 80b-9(e)(1).
[172] 15 USC §§ 77h-1(e), 78u-3(e), 80a-9(f)(5), 80b-3(k)(5).
[173] 15 USC §§ 77h-1(g), 78u-2(a)-(b), 80a-9(d)(1)-(2), 80b-3(i)(1)-(2).
[174] See 15 USC §§ 78o(b)(4), (b)(6)(A); 80b-3(e), (f).
[175] 15 USC § 80b-3(e)-(f).
[176] 15 USC § 80b-3(e)(3), (5), (f).
[177] *Mathis v. SEC*, 671 F.3d 210, 217 (2d Cir. 2012).
[178] *Mathis v. SEC*, 671 F.3d 210, 217 (2d Cir. 2012); *SEC v. Moran*, 922 F. Supp. 867, 900 (S.D.N.Y. 1996).

severe sanctions would be unwarranted.[179] Bars, on the other hand, can be a very severe sanction and may be permanent. The SEC, however, frequently permits the barred person to apply for re-association after a specified period of time.

Remedies in criminal actions

Violations of the Securities Act of 1933, the Investment Company Act of 1940 and the Investment Advisers Act of 1940 each carry the possibility of $10,000 in fines and/or up to five years in prison.[180]

Violations of the Securities Exchange Act of 1934 (including Rule 10b-5) carry the potential for $5 million in fines for a natural person ($25 million for an entity) and/or 20 years in prison.[181] In addition, the DOJ/USAO may seek sentences as long as 25 years for securities fraud under Title 18 of the United States Code (USC).

Under the Mandatory Victims Restitution Act (MVRA), defendants may also be required to pay restitution to the victims of their crimes.[182] This statute imposes mandatory restitution in favour of identifiable victims of crimes against property, including *"any offense committed by fraud or deceit."*[183] The statute applies to securities fraud crimes.[184] Courts have therefore ordered restitution in favour of victims of insider trading and market manipulation, including a restitution award of almost $17.5 million against a defendant involved in a 'pump and dump' manipulation scheme, which was upheld by a federal appeals court in August 2013.[185]

The amount of restitution must include, among other things, the victims' pecuniary loss resulting from the offence plus any *"necessary . . . other expenses incurred during participation in the investigation or prosecution of the offense."*[186] Among the 'necessary other expenses', courts have ordered defendants to pay their employer's legal fees incurred in investigating the defendants' wrongdoing.[187]

Collateral consequences: bad actor disqualification

The consequences of an enforcement action may extend beyond the injunction, penalty or disgorgement order itself. Individuals and entities involved in enforcement proceedings may suffer significant collateral consequences such as disqualification from utilising exemptions from securities offering registration requirements. Under these 'bad actor' provisions, issuers are disqualified from relying on exemptions (for example,

[179] Mahoney, *supra*, at A-103.
[180] 15 USC §§ 77x, 80a-48, 80b-17.
[181] 15 USC § 78ff(a).
[182] 18 USC § 3663A.
[183] 18 USC § 3663A(c)(1)(A)(ii).
[184] *United States v. Dupes*, 513 F.3d 338, 345 (2d Cir. 2008) (*"The MVRA makes full restitution mandatory for certain crimes, including securities fraud . . . ."*).
[185] See *United States v. Gushlak*, 728 F.3d 184 (2d Cir. 2013).
[186] 18 USC § 3663A(b).
[187] *United States v. Amato*, 540 F.3d 153, 159 (2d Cir. 2008); *United States v. Gordon*, 393 F.3d 1044, 1056–57 (9th Cir. 2004).

Regulations A and D promulgated pursuant to the Securities Act) if the issuers, or certain other relevant persons, *"have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws."*[188]

Regulation A provides an exemption from registration for offerings of securities that do not exceed $5 million in any 12-month period, provided certain other requirements are met.[189] The bad actor provision in Regulation A, however, denies the exemption if the issuer or certain affiliates (such as officers, directors, or significant shareholders) violated the securities laws in the previous five years.[190] The SEC's Division of Corporate Finance may waive the disqualification for 'good cause'.[191]

Of greater importance to private investment funds and their investment advisers, Regulation D provides exemptions through three different rules: Rules 504, 505, and 506.

Rule 506, which permits offerings of unlimited dollar amounts, is frequently used by private funds and, in fact, accounts for an estimated 90 percent to 95 percent of all Regulation D offerings.[192] In July 2013, the SEC, under section 926 of Dodd-Frank, announced rules for a bad actor provision in Rule 506, which did not previously have one.[193] Dodd-Frank required the bad actor provision in Rule 506 to be 'substantially similar' to the provision in Regulation A.[194] In December 2013, the SEC's Division of Corporate Finance answered questions about its interpretation of the provision, including its view that disqualification will not be triggered by judgements of foreign courts or by Rule 105 violations.[195] Bad actor provisions in Regulation D exemptions can also be waived by the SEC.

Private fund managers relying on Regulation D for their funds' offerings are well advised to negotiate for a waiver with the SEC at the time of any settlement.

Case study 1: Expert networks

Reducing the risk of insider trading actions from the use of expert networks

Over the last few years, the use by private investment funds of expert networks has resulted in a significant number of insider trading enforcement actions and prosecutions. Expert network firms are research consulting firms, which arrange to connect

[188] *Disqualification of Felons and Other 'Bad Actors' from Rule 506 Offerings*, Securities Act Release No. 33-9414, at 7 (July 10, 2013) at: www.sec.gov/rules/final/2013/33-9414.pdf (Release No. 33-9414).
[189] SEC, Release No. 33-9414, *supra*, at 8 n.23; see generally 17 CFR § 230.251–230.263.
[190] 17 CFR § 230.262.
[191] 17 CFR §§ 200.30-1(b)(1), 230.262.
[192] SEC, Release No. 33-9414, *supra*, at 5–6.
[193] SEC, Release No. 33-9414, *supra*, at 7–8.
[194] SEC, Release No. 33-9414, *supra*, at 8.
[195] See Schulte Roth & Zabel, Alert: SEC Releases 'Bad Actor' Rule Guidance (December 11, 2013).

investors with subject-matter experts who can offer market intelligence based on their specialised knowledge in a particular field, such as healthcare or technology.

As a general matter, expert networks are entirely legal and can help investors gain detailed knowledge about an industry, market, company, product or event prior to making an investment in a particular company. Problems arise, however, if and when these experts, who may be company insiders, former insiders or consultants to the issuer (such as, for example, doctors involved in clinical trials for pharmaceutical companies), share material non-public information with the investors in breach of a duty of trust or confidence.

Outcome

As of November 2012, the SEC had charged 28 defendants as part of its investigation of expert networks and a number of individuals were criminally prosecuted.[196] For instance, Connecticut-based hedge fund Level Global was raided by the FBI as part of the government's investigation into the use of expert networks and a number of fund managers and analysts pleaded guilty for their roles in related insider trading based on information obtained via consultations with experts arranged through expert network firm Primary Global Research.[197]

Lessons learned

1. *Conduct due diligence on the expert network firm.* Funds looking to utilise expert network firms should fully vet those firms. In particular, funds should satisfy themselves that the expert network firm has effective compliance policies and procedures in place to ensure that its experts do not share material non-public information in breach of a duty of trust or confidence. Funds may also consider requiring the expert to confirm in writing that he or she agrees not to share material non-public information.
2. *Utilise internal compliance procedures and training.* Funds should adopt effective policies and procedures governing the use of expert networks designed to ensure that they are used legally. For instance, funds might consider requiring that consultations with experts be pre-approved by legal and/or compliance and that the expert not be employed (either as an employee or a consultant) by a company in which the fund has an investment or is planning to invest. Funds

[196] See Ronald D. Orol, *Expert Networks Key to SEC Insider Trading Cases*, MarketWatch (November 21, 2012); see also Schulte Roth & Zabel LLP, *Insider Trading Law and Compliance Answer Book 2014*, at 387–94 (Harry S. Davis ed., 2013).

[197] The insider trading convictions of Level Global's founder Anthony Chiasson and hedge fund Diamondback Capital portfolio manager Todd Newman were reversed by the US Court of Appeals for the Second Circuit in December 2014. See *United States v. Newman*, 2014 WL 6911278 (2d Cir. December 10, 2014). The court reversed the convictions because the government failed to prove both (i) that the sources of the inside information received a consequential benefit in exchange for their tips, and (ii) that Chiasson and Newman knew that the sources of the inside information received a personal benefit in exchange for their tips.

might also consider limiting the number of times that individual experts may be consulted and even might consider having legal and/or compliance monitor communications with experts. Funds should also adopt training programmes to give their employees guidance on the types of questions that can and cannot be asked of the experts. □

Case study 2: Lessons from the Quantek case

In the Matter of Quantek Asset Management LLC
(SEC Administrative Proceeding File No. 3-14893, May 29, 2012)

The SEC brought this administrative proceeding against a prominent Miami-based hedge fund adviser (Quantek), its parent company (Bulltick) and two Quantek officers (Javier Guerra and Ralph Patino).

Quantek managed two investment funds (the Opportunity Funds), which focused primarily on making loans to industrial and real estate ventures in Latin America. The SEC focused on three categories of misconduct:

1. Misrepresentations regarding whether and to what extent the principals of Quantek had invested their own wealth in the Opportunity Funds; this is what the SEC referred to as 'skin-in- the-game.'
2. Quantek's failure to follow stated processes for approving investments.
3. Quantek's providing inaccurate information regarding certain related-party transactions.

Skin-in-the-game. 'Skin-in-the-game' refers to principals' investments of their own money in the funds they manage and is a generally recognised indicator that the principals' interests are aligned with the interests of their investors. Quantek completed certain due diligence questionnaires for investors indicating that its principals had $13 million invested in the Opportunity Funds or in other vehicles managed '*pari passu*' (meaning, essentially, in unison) with the Opportunity Funds. In fact, however, the principals' investments were in 'unrelated vehicles' and the $13 million response was therefore inaccurate.

Investment process. Quantek's offering documents indicated that it would prepare a formal investment memorandum for each potential investment and present those memoranda to a five-member investment committee for written approval. This process was important to investors because the Opportunity Funds were investing in complex and illiquid loans and Quantek, a relatively new adviser, did not yet have an established performance record. Quantek, however, grew rapidly from $10 million in assets to approximately $635 million in assets a year later and failed to follow its stated process for at least 15 investments, totaling more than half of the Opportunity Funds' portfolio. Not only did Quantek fail to prepare and obtain written approval of investment memoranda for these invest-

ments, when asked by a major investor for copies of the investment memoranda, Quantek created backdated memoranda to give the impression that its process had been followed all along.

Related-party transactions. The Opportunity Funds' governing documents permitted related-party transactions, but Quantek, in some cases, failed to correctly document them. For instance, the Opportunity Funds made an unsecured $800,000 loan to a company controlled by Guerra for a real estate investment in New York City. Months later, however, Quantek recorded the loan, and reported it to investors, inaccurately as a secured transaction with a Bulltick subsidiary called Equus for an investment in Latin America.

Outcome

Quantek settled non-scienter-based charges that it violated certain provisions of the Securities Act and the Investment Advisors Act with the respondents neither admitting nor denying the SEC's findings. The respondents agreed to pay over $3 million in disgorgement, pre-judgement interest and civil penalties. Guerra was barred from the securities industry for five years and Patino was barred for one year.

Lessons learned

Skin-in-the-game. Principals must understand exactly how their co-investments are structured. The principals in *Quantek* may have thought they had their money invested in something similar to the Opportunity Funds, but the SEC found that those investments were 'unrelated' and thus that the principals' skin-in-the-game representations were false. If there is any ambiguity in the nature of a principal's potential co-investment, consider explaining precisely how that investment is structured.

Investment process. For funds growing rapidly, it can be easy for certain processes to fall through the cracks, but when fund managers tell their investors that they follow a certain process, the SEC is likely to take notice when the managers fail to follow through on that promise. If a fund has issues following its processes as it grows, it can either adopt new processes acceptable to its investors or slow the pace of growth and build up the capabilities necessary to follow established processes going forward. Whatever the issue, the worst thing a fund can do is, like Quantek, create backdated documents giving the false impression that the fund was following its process all along.

Related-party transactions. Related-party transactions are an important issue for both the SEC and investors. Funds that permit related-party transactions must ensure that they are adequately disclosed beforehand and properly documented throughout the course of the transaction. □

Conclusion

The regulatory environment in which private investment funds operate is undoubtedly complex and the potential for missteps and serious consequences is real. However, risks

can be mitigated at least in part by understanding that environment and the types of issues most likely to draw the attention of the authorities. Funds can use that knowledge to create appropriate policies and procedures aimed at preventing unlawful activity from the outset and, in the event of an investigation or enforcement action, to appropriately respond to or defend themselves in those proceedings. Finally, consultation with experienced legal counsel is critical to navigating the regulatory minefield safely. □

Harry S. Davis *is a partner at Schulte Roth & Zabel LLP in New York. His practice focuses on complex commercial litigation and regulatory matters for financial services industry clients, including hedge funds, funds of funds and private equity funds, prime and clearing brokers, and auditors and administrators. Harry has substantial experience in both securities regulatory matters and private litigation, including investigations by the SEC, the USAO and DOJ, the CFTC, the Federal Trade Commission, state attorneys general, state securities regulators and self-regulatory organisations. Harry also frequently provides litigation and compliance counseling to clients, to prevent minor issues from growing into bigger problems.*

Brian Burns *is an associate in the litigation department at Schulte Roth & Zabel LLP in New York. Brian previously served as a law clerk for Judge Richard J. Holwell and Judge William H. Pauley III in the US District Court for the Southern District of New York.*

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LONDON
140 London Wall, 6th Floor
London EC2Y 5DN
United Kingdom

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16 West 46th Street, 4th Floor
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United States

HONG KONG
14/F, Onfem Tower
29 Wyndham Street
Central, Hong Kong