Having trouble reading this email? View it in your browser Print email

OnPoint Dechert LLP

December 2012
A legal update from Dechert's Financial Services Group

Head of Asset Management Unit at SEC Enforcement Shares Hedge Fund Enforcement Priorities

In a recent speech, Bruce Karpati, Chief of the Asset Management Unit (AMU)[1] within the Division of Enforcement (Division) of the U.S. Securities and Exchange Commission (SEC), discussed his view of the current enforcement priorities of the Division, in general, and the AMU, in particular, in relation to hedge funds.[2] The AMU's current key enforcement priorities for hedge funds include:

- Valuation manipulation;
- Self dealing;
- Preferential treatment for certain investors; and
- Misleading marketing.

The AMU is particularly focused on these potential abuses in relation to hedge funds, based on its view that hedge funds are more likely to invest in complex and illiquid assets and have less transparent organizational structures than registered funds. Mr. Karpati also indicated that the heightened scrutiny of hedge funds is attributable to the growing number of retail investors who are indirectly exposed to hedge funds via pension plans, retirement plans and similar pooled accounts, as well as the expectation that the Jumpstart Our Business Startups Act (JOBS Act) will only increase retail investors' exposure to hedge funds. The following summarizes Mr. Karpati's remarks.

Managers' Fiduciary Duties are a Framework for AMU Investigations

When the AMU investigates hedge fund managers, it focuses on the fiduciary duties that a manager owes to its advised funds and their investors. Under the Investment Advisers Act of 1940 (Advisers Act), investment advisers owe "an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' . . . clients."[3] Given these obligations, hedge fund managers must guard against the incentives that conflict with their fiduciary duties to provide disinterested advice and advisory services in the best interest of investors.

Hedge Fund Incentives May Create Tension with Fiduciary Duties

Mr. Karpati stated that certain aspects of hedge funds tend to create incentives that are potentially misaligned with the interests of investors. These include:

- **Fee Structure.** Hedge fund managers are typically compensated through both management fees and incentive compensation. Incentive compensation, in particular, can increase the emphasis that managers place on generating fees, creating an incentive for managers to inflate performance, for example by overvaluing certain assets.
- **Pressure to Generate Consistent Positive Results.** Given their relatively high fee structures and competition from other funds, hedge fund managers face pressure to continuously show performance metrics that make their funds attractive to new investors and retain current investors. However, as the hedge fund industry has grown, many fund managers have found it difficult to continue to consistently produce the high returns that hedge fund investors have come to expect. The combination of increased competition and high profit expectations can create pressure for managers to go to ever greater lengths to obtain an informational edge on the market, including the use of insider

information.

- **Related Party Transactions.** Because managers are more likely to control multiple components of the services performed for a fund and its investors in the hedge fund context than in the registered fund context, there are more opportunities to engage in self dealing. The generally increased number of related party transactions, combined with profit and fund performance incentives, can create an incentive for hedge fund managers to either misappropriate profits or hide losses through self-serving transactions with related parties.
- **Lack of Independent Governance.** Because hedge funds generally do not have an independent board or other independent governors, there is often no independent check to protect investor interests when they diverge from those of the manager. The absence of an independent check creates an increased need for hedge fund managers to implement appropriate compliance procedures. The AMU and other groups within the SEC Staff, particularly the examination staff in the Office of Compliance Inspections and Examinations (OCIE), will focus on managers' compliance procedures.[4]

Need for Regulatory Oversight of Hedge Funds

Mr. Karpati stated, "[w]e firmly believe that in order to protect investors, the industry needs vigilant enforcement oversight and, over the last few years, we have observed certain behavior by hedge funds that highlights the need for such oversight." In his speech, Mr. Karpati highlighted ten of the more than 100 cases brought by the AMU against hedge fund managers since 2010.[5] Examples of behavior by private fund managers that led to these actions included: manipulating valuations to inflate fees and/or performance; self-interested transactions with related parties to misappropriate profits or hide losses; preferential redemptions for strategically important investors to the disadvantage of other investors; and marketing materials that materially misstated key terms on which a reasonable investor would likely rely when making investment decisions.

Beyond the often intentional violations that lead to enforcement actions, Mr. Karpati also touched on related but unintended trouble spots for hedge funds to guard against, including: weak valuation policies and lack of adequate oversight; firm policies and procedures that do not adequately address the conflicts of interest that a particular firm and its staff actually face; lack of adequate documentation and disclosure related to any divergent redemption or liquidity rights for different investors in a fund; and lack of adequate diligence and controls in relation to the review and publication of marketing materials.

Steps Managers Can Take

Mr. Karpati suggested that managers can take the following steps to help ensure that they are fulfilling their fiduciary duties:

- **Establish a Culture of Compliance.** Hedge fund staffs, like those of most other types of organizations, often take cues from their top leadership. Hedge fund managers can set the right "tone at the top" by placing an emphasis on compliance in addition to managing and marketing activities. Further, hedge fund managers should ensure that robust valuation, conflicts of interest and marketing policies are in place, and that there are sufficient resources available to fully implement these policies.
- **Make Sure Compliance Policies Fit the Investment Strategy and the Firm.** Although the size of the funds managed may affect the level or scope of compliance controls that are appropriate, all firms should routinely perform a comprehensive review of their compliance policies and procedures and update them to fit the specific risks facing the organization. Given the current enforcement priorities, hedge fund managers should likely focus particular attention on valuation, conflicts of interest and marketing policies and procedures. For example, firms investing in complex or illiquid instruments should ensure that they have appropriate valuation policies that reflect the types of assets being managed, and consider routinely testing and verifying the accuracy of the outputs generated through the application of those procedures.
- **Be Prepared for Exam Inquiries.** In addition to maintaining the books and records required by the Advisers Act, hedge fund managers should expect to be examined and may wish to anticipate exam inquiries in determining how to keep records and what records to keep. By cooperating with examiners and promptly implementing corrective measures to address issues that have been identified by the SEC or its staff during an examination of the adviser, or that the adviser otherwise becomes aware of, a

manager can help the examination process move more efficiently and reduce the chance of a more formal inquiry or enforcement action.

Footnotes

1) The AMU is a specialized unit that, together with the Market Abuse Unit and the Structured and New Products Unit, works to generate expertise to assist the Division of Enforcement in overseeing a growing and ever more complex fund industry.

2) Bruce Karpati, Chief, Division of Enforcement's Asset Management Unit, U.S. Securities and Exchange Commission, Remarks before the Regulatory Compliance Association (Dec. 18, 2012), *available here.*

3) SEC v. Capital Gains Research Bureau, Inc. 275 U.S. 180, 194 (1963). In general, for advisers to funds, the fund is the investment adviser's client. See Goldstein v. SEC, 451 F.3d 873, 882-84 (D.C. Cir. 2006). However, Sections 206(1) and (2) of the Investment Advisers Act of 1940 and Rule 206(4)-8 extend certain protections to fund investors.

4) In particular, OCIE has launched a presence exam initiative designed to conduct focused risk-based examinations of investment advisers to private funds that recently registered with the SEC. *See* Letter from SEC, Office of Compliance Inspections and Examinations, to Newly Registered Investment Advisers (Oct. 9, 2012), *available here* (PDF).

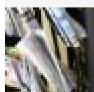
5) In some cases the allegations of these behaviors are still pending, and in many they involve settled actions where the party neither admitted nor denied the allegations.

This update was authored by:

Michael L. Sherman
Washington, DC
Send an email
T: +1 202 261 3449

David A. Vaughan
Washington, DC
Send an email
T: +1 202 261 3355

Jonathan R. Massey
San Francisco
Send an email
T: +1 415 262 4539



To browse our library of legal updates, please visit dechert.com/publications

Dechert's Financial Services Group has approximately 160 lawyers across the United States, Europe, Asia and the Middle East. To see the full list of lawyers, please visit our website.

Unsubscribe | Manage my mailings | Forward to a colleague   dechert.com

© 2012 Dechert LLP. All rights reserved. This publication should not be considered as legal opinions on specific facts or as a substitute for legal counsel. It is provided by Dechert LLP as a general informational service and may be considered attorney advertising in some jurisdictions. Prior results do not guarantee a similar outcome. We can be reached at the following postal addresses: in the US: 1095 Avenue of the Americas, New York, NY 10036-6797 (+1 212 698 3500); in Hong Kong: 27/F Henley Building, 5 Queen's Road Central, Hong Kong (+852 3518 4700); and in the UK: 160 Queen Victoria Street, London EC4V 4QQ (+44 20 7184 7000).

Dechert internationally is a combination of separate limited liability partnerships and other entities registered in different jurisdictions. Dechert has more than 800 qualified lawyers and 700 staff members in its offices in Belgium, China, France, Germany, Georgia, Hong Kong, Ireland, Kazakhstan, Luxembourg, Russia, the United Arab Emirates, the UK and the US. Further details of these partnerships and entities can be found at dechert.com on our Legal Notices page.

IRS Circular 230 disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to

another party any transaction or matter addressed herein.