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## SEC Enforcement and Examinations Concerning Hedge Funds

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BARRY W. RASHKOVER AND LAURIN BLUMENTHAL KLEIMAN

## SEC Enforcement and Examinations Concerning Hedge Funds

**ABOUT THE AUTHORS:** Mr. Rashkover and Ms. Kleiman are partners in the New York office of Sidley Austin LLP. Mr. Rashkover is a litigator specializing in defending financial institutions and other companies in securities enforcement matters and litigation. Ms. Kleiman specializes in representing investment funds and investment advisers, including counseling in connection with U.S. federal and state investment adviser regulation and compliance. This article is a private publication of the authors, expresses only the authors' views, and does not necessarily reflect the views of Sidley Austin LLP or any client of the firm. This article is an outgrowth of a presentation by Mr. Rashkover at New York Law School's symposium, *Corporate Governance Five Years After Sarbanes-Oxley: Is There Real Change?*, held in April 2007. The authors express their appreciation to Joyce E. Larson, compliance project specialist at Sidley Austin; Rebecca Ebert, a Sidley Austin associate; and Sidley Austin 2007 summer associates, Jon W. Muenz and Nicholas J. Alexiou, for assisting in the preparation of this article. This article is generally current as of December 2007.

## I. INTRODUCTION

To look at some recent events, one might question the government's success or resolve in regulating hedge funds. In 2006, for example, the D.C. Circuit Court of Appeals dealt a setback to the Securities and Exchange Commission ("SEC" or the "Commission") concerning hedge fund regulation. It held that the SEC had overstepped its statutory boundaries when it adopted a rule that had required certain hedge fund advisers to register with the Commission under the Investment Advisers Act of 1940 (the "Advisers Act").<sup>1</sup> Similarly, in a February 2007 report, a group of senior government officials—including Treasury Secretary Henry Paulson—concluded that there was no need for further hedge fund regulation.<sup>2</sup>

These events, however, do not reflect the realities on the ground. The SEC increasingly has identified hedge funds as a major priority of its enforcement and examination programs. Last year, for example, the Commission staff reported at the March 2006 Practising Law Institute's "SEC Speaks" conference that the SEC had brought over thirty hedge fund cases in recent years.<sup>3</sup> That same month, at a panel at the Securities Industry Association's Compliance & Legal Division Seminar, SEC Enforcement Director Linda Chatman Thomsen predicted that the SEC enforcement would continue emphasizing hedge fund cases.<sup>4</sup> Furthermore, in a March 2007 speech, she said:

We have been following the money (and there has been a lot of money to follow to hedge funds). We continue to see too many examples of fraud by hedge fund managers involving the funds they manage and investors in those funds. These frauds run the gamut—we've seen theft of assets, fraudulent valuations of securities held by the fund, and false information provided to investors about performance and other important matters.<sup>5</sup>

Simply put, hedge funds and issues concerning them are—and likely will remain—important focus areas for regulators, the SEC in particular.

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1. Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

2. See PRESIDENT'S WORKING GROUP ON FIN. MKTS., AGREEMENT AMONG PWG AND U.S. AGENCY PRINCIPALS ON PRINCIPLES AND GUIDELINES REGARDING PRIVATE POOLS OF CAPITAL (2007), available at [http://www.treasury.gov/press/releases/reports/hp272\\_principles.pdf](http://www.treasury.gov/press/releases/reports/hp272_principles.pdf); see also Press Release, President's Working Group on Fin. Mkts., President's Working Group on Financial Markets Releases Common Approach to Private Pools of Capital, Guidance on Hedge Fund Issues, Focuses on Systemic Risk, Investor Protection (Feb. 22, 2007), available at <http://www.treas.gov/press/releases/hp272.htm>.

3. See *Highlights from "SEC Speaks" 2006*, SEC UPDATE (Sidley Austin LLP, New York, N.Y.) (Mar. 17, 2006).

4. See Barry W. Rashkover & Rebecca F. Ebert, *SEC Enforcement in the Cox Era*, 39 REV. OF SEC. & COMMODITIES REG. 185, 198 (2006).

5. Linda Chatman Thomsen, Dir., Div. of Enforcement, SEC, Remarks Before the IA Week and the Investment Adviser Association 9th Annual IA Compliance Best Practices Summit 2007 (Mar. 22, 2007), available at <http://www.sec.gov/news/speech/2007/spch032207lct.htm> [hereinafter Remarks Before the IA Week].

This article surveys the landscape of SEC enforcement and examination initiatives concerning hedge funds. Part II highlights key enforcement actions that the SEC recently has brought against hedge funds or their personnel and actions that otherwise involve issues related to hedge funds. Part III looks at the examination process and discusses issues SEC examination staff are emphasizing during their reviews of registered investment advisers. Part IV notes certain changes in the SEC enforcement process in general since Christopher Cox became SEC chairman in 2005, and what those changes can mean regarding hedge funds.

## II. SEC ENFORCEMENT ACTIONS

Recent SEC enforcement actions concerning hedge funds have addressed the impact of hedge funds on the securities markets, as well as the abuses certain hedge fund advisers have allegedly caused their funds and investors. In other cases, the SEC has charged broker-dealers for allegedly facilitating or causing hedge fund violations.

### A. Basic Insider Trading Cases

Perhaps the most high-profile recent SEC enforcement actions concerning hedge funds have involved alleged insider trading. The Commission staff has made a priority of insider trading generally, evident through several recent cases involving securities industry professionals. Many of those cases have involved hedge funds or individuals working for them.

In *SEC v. Guttenberg*, for example, the Commission brought charges for alleged illegal insider trading through two trading rings, both of which included hedge fund tippees.<sup>6</sup> The first trading ring began with a research analyst, Mitchel Guttenberg of UBS Equity Research, who allegedly tipped others with nonpublic information about upcoming analyst recommendations.<sup>7</sup> His alleged tippees included Erik Franklin, a trader for two hedge funds, Lyford Cay Capital, LP and Q Capital Investment Partners, LP; David Tavdy, who traded for two broker-dealers, Andover Brokerage, LLC and Assent LLC; and Jasper Capital LLC, a day-trading firm.<sup>8</sup> Franklin and Tavdy, in turn, allegedly tipped others, including Mark Lenowitz, who traded for the hedge fund Chelsey Capital, and Robert Babcock, who traded for the hedge fund Lyford Cay.<sup>9</sup> This trading ring allegedly generated an aggregate of \$14 million in illegal profits.<sup>10</sup> The

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6. SEC v. Guttenberg, Litigation Release No. 20022, 2007 SEC LEXIS 383 (Mar. 1, 2007), available at <http://www.sec.gov/litigation/litreleases/2007/lr20022.htm>.

7. *Id.* at \*2.

8. *Id.* at \*2-3.

9. *Id.*

10. *Id.* at \*4.

second trading ring started with a Morgan Stanley compliance lawyer, Randi Collotta, along with her husband Christopher, who tipped others about upcoming mergers and other transactions.<sup>11</sup> This ring also included individuals who traded for hedge funds, including Erik Franklin, mentioned above.<sup>12</sup> This trading ring allegedly received \$600,000 in aggregate illegal profits.<sup>13</sup>

*Guttenberg* is interesting for several reasons. First, it involves not just civil SEC charges, but criminal charges as well.<sup>14</sup> So far, one set of defendants, Collotta and her husband, have pleaded guilty to criminal charges in connection with the scheme.<sup>15</sup> Second, the case is interesting for the lengths to which one defendant, Guttenberg, allegedly went to avoid detection—using disposable cell phones and coded text messages to tip the hedge fund trader, Franklin.<sup>16</sup> Finally, the case is interesting because although the trading allegedly yielded sizeable profits in the aggregate, the trades alleged in the complaint actually involved relatively modest profits, mostly four figures, when viewed individually—possibly suggesting attempts by the members of the ring to fly “under the radar.”<sup>17</sup>

Earlier in 2007, the Commission staff highlighted another case as an example of hedge fund insider trading. In *SEC v. Aragon Capital Management LLC*, the SEC’s complaint alleged that, between 2001 and 2005, Zvi Rosenthal, a vice president at Taro Pharmaceuticals Industries, Ltd., traded on material nonpublic information ahead of eight Taro Pharmaceuticals earnings announcements and tipped others, including Zvi’s son, Amir Rosenthal, who traded in the account of the family-owned hedge fund, Aragon Partners, LP.<sup>18</sup>

#### B. PIPE Cases: Insider Trading, Fraud, and Violations of Securities Act Section 5

The SEC has brought a handful of cases in which hedge funds have shorted stock in advance of Private Investment in Public Equity (“PIPE”) offerings. Some of these cases have involved insider trading and other types of fraud, while a number have involved interesting allegations that the short sales violated Sec-

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11. *Id.*

12. *Id.* at \*5.

13. *Id.*

14. See Press Release, U.S. Attorney S. Dist. of N.Y., UBS Executive and Former Morgan Stanley Lawyer Among 13 Charged in Massive Insider Trading Schemes (Mar. 1, 2007), available at <http://www.usdoj.gov/usao/nys/pressreleases/March07/ubsinsidertradingpr.pdf>.

15. *Id.*

16. See *Guttenberg*, 2007 SEC LEXIS 383.

17. Linda Chatman Thomsen, Dir., Div. of Enforcement, SEC, Statement Concerning *SEC v. Guttenberg* (Mar. 1, 2007), available at <http://www.sec.gov/news/speech/2007/spch030107lct.htm>.

18. *SEC v. Aragon Capital Mgmt. LLC*, Litigation Release No. 19995A, 2007 SEC LEXIS 295 (Feb. 13, 2007), available at <http://www.sec.gov/litigation/litreleases/2007/lr19995a.htm>.

tion 5 of the Securities Act of 1933 (the “Securities Act”)<sup>19</sup>—although, as noted below, at least two district courts very recently rejected the Commission’s Section 5 charges in PIPEs cases. Section 5, among other things, generally makes it unlawful to sell a security unless a registration statement is in effect or unless certain exemptions apply.

In a March 2006 civil action, the Commission alleged that three hedge funds, Langley Partners, LP, North Olmsted Partners, LP, and Quantico Partners, LP, and their portfolio manager, Jeffrey Thorp, engaged in a fraudulent trading scheme to “evade the registration requirements of the federal securities laws in connection with twenty-three unregistered securities offerings . . . [of] ‘PIPEs.’”<sup>20</sup> Once they had agreed to invest in a PIPE transaction, the defendants “typically sold short the issuer’s [not yet registered] stock, frequently through ‘naked’ short sales<sup>21</sup> in Canada.”<sup>22</sup> In so doing, the defendants violated representations to the PIPE issuers that they would not sell the PIPE stock before registration and also engaged in insider trading through the short sales, in violation of the Securities Exchange Act of 1934 (the “Exchange Act”) Section 10(b) and Rule 10b-5. Applying a legal theory that at least two district courts have since rejected, the SEC further alleged that the funds violated Section 5 of the Securities Act because later—after the registrations for the PIPE stock became effective—the funds used those PIPE shares to cover the short positions.<sup>23</sup> To conceal that conduct, the defendants allegedly employed deceptive trading techniques, including wash sales and matched orders, to create the appearance that they were covering the short positions with open market purchases, not the newly registered PIPE stock.<sup>24</sup> Among other remedies, the hedge funds consented to disgorge \$8.8

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19. 15 U.S.C. § 78e (2000).

20. SEC v. Langley Partners, LP, Litigation Release No. 19607, 2006 SEC LEXIS 594 (Mar. 14, 2006), available at <http://www.sec.gov/litigation/litreleases/lr19607.htm>.

21. SEC, NAKED SHORT SALES (2007), <http://www.sec.gov/answers/nakedshortsale.htm> (“In a ‘naked’ short sale, the seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer within the standard three-day settlement period. As a result, the seller fails to deliver securities to the buyer when delivery is due; this is known as a ‘failure to deliver’ or ‘fail.’”).

22. See *Langley Partners*, 2006 SEC LEXIS 594.

23. *Id.* This Section 5 theory effectively deems the defendant to have shorted the PIPE stock before it was registered because, post-registration, the defendants use that PIPE stock to cover the shorts. Rejecting that theory to date are SEC v. Lyon, No. 06 Civ. 14338, 2008 U.S. Dist. LEXIS 9, at \*27, \*30 (S.D.N.Y. Jan. 2, 2008) (“ . . . from the Court’s perspective, a short sale of a security constitutes a sale of that security. How an investor subsequently chooses to satisfy the corresponding deficit in his trading account does not alter the nature of that sale. . . . Thus, no interest in the PIPE shares is alleged to have been transferred prior to the effective dates of the relevant resale registration statements. . . .”) and Transcript of Hearing at 44, SEC v. Mangan, No. 06-CV-531 (W.D.N.C. Oct. 24, 2007) (“ . . . what we have here. . . is a post hoc ergo propter hoc argument by the government that because the PIPE in fact was not registered and because the PIPE shares were later in fact used, he in effect sold the PIPE. Well, maybe, but I don’t think he did anything illegal. In short, no sale of unregistered securities occurred as a matter of law.”).

24. *Langley Partners*, 2006 SEC LEXIS 594.

million in illegal profits, and the hedge funds and Thorp agreed to pay civil penalties totaling \$7 million.<sup>25</sup>

In January 2007, the SEC filed an action involving similar facts against Joseph J. Spiegel, “a former portfolio manager for Spinner Global Technology Fund, Ltd. (“SGTF”), a New York-based hedge fund.”<sup>26</sup> The SEC alleged that Spiegel violated the antifraud and registration provisions of the federal securities laws by engaging in naked short selling in Canada in advance of three PIPE offerings and later covering those short positions with the PIPE stock once it became freely tradable.<sup>27</sup> Spiegel’s naked short selling, which came after defendants learned about the PIPE offerings, allegedly violated representations SGTF made to the PIPE issuers that SGTF would not sell the PIPE stock before that stock’s registration became effective.<sup>28</sup> Later, “Spiegel employed wash sales and matched orders to make it appear that he was covering SGTF’s pre-effective date short positions with open market stock purchases,” rather than with the newly registered PIPE stock.<sup>29</sup> Spiegel consented to the entry of an injunction and a \$110,000 civil penalty.<sup>30</sup> He also agreed to the issuance of an administrative order “barring him from association with an investment adviser, with a right to reapply in three years.”<sup>31</sup>

In 2005, the Commission filed a civil action and an administrative proceeding against Hilary Shane for alleged insider trading and unregistered sales of securities in connection with a PIPE offering.<sup>32</sup> Shane, an investment adviser for a broker-dealer, primarily managed the portfolios of, and provided investment advice to, certain hedge funds.<sup>33</sup> In 2001, she elected to participate in a PIPE offering by CompuDyne, a Maryland-based safety and security company, for both her personal account and that of a hedge fund she managed.<sup>34</sup> After executing the purchase agreement, including a confidentiality provision, she proceeded to sell short shares of CompuDyne in both accounts, making substantial

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25. *Id.*

26. SEC v. Joseph J. Spiegel, Litigation Release No. 19956, 2007 SEC LEXIS 7 (Jan. 4, 2007), *available at* <http://sec.gov/litigation/litreleases/2007/lr19956.htm>.

27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.*

31. *Id.*

32. SEC v. Hilary L. Shane, Litigation Release No. 19227, 2005 SEC LEXIS 1158 (May 18, 2005), *available at* <http://www.sec.gov/litigation/litreleases/lr19227.htm> [hereinafter Shane Litigation Release]; *see also In re Hilary L. Shane*, Exchange Act Release No. 51839, Investment Advisers Act Release No. 2395, 2005 SEC LEXIS 1390 (June 14, 2005), *available at* <http://www.sec.gov/litigation/admin/34-51839.pdf> [hereinafter Shane Exchange Act Release].

33. *See* Shane Exchange Act Release, 2005 SEC LEXIS 1390.

34. Shane Litigation Release, 2005 SEC LEXIS 1158, at \*2–3.

profits.<sup>35</sup> By short selling CompuDyne securities before the effective date of the resale registration statement and then covering her short sales with the PIPE shares after the resale registration statement became effective, Shane allegedly engaged in insider trading and sold the shares prior to their registration in violation of Section 5 of the Securities Act.<sup>36</sup> Shane consented to paying disgorgement and civil penalties of \$1 million, a permanent bar from association with any broker-dealer, and a twelve-month suspension from association with any investment adviser.<sup>37</sup>

*C. Violations of Rule 105 of Regulation M under the Exchange Act*

The SEC has brought many cases involving scenarios in which a trader shorts a stock during the five-day “restricted period” before the pricing of a follow-on offering, buys into the offering, and then uses the offering stock to cover the short.<sup>38</sup> This can prove profitable as the price of the stock drops through the restricted period and the trader acquires the offering stock at a discount from the price at which he shorted. This trading sequence violates Rule 105 of Regulation M under the Exchange Act.<sup>39</sup> For years, Rule 105 generally has prohibited the use of stock acquired from an underwriter in a follow-on offering to cover short sales effected in the same stock during the five-day restricted period. “The Commission has long been concerned that short sales effected prior to certain offerings that are covered with offering securities can be manipulative conduct harmful to the market and can have a substantial impact on issuers or selling security holders.”<sup>40</sup> Under a new amendment to Rule 105, investors shorting a stock during the five-day restricted period preceding a follow-on offering by the issuer may not acquire stock from an underwriter in that follow-on offering at all, except under limited circumstances.<sup>41</sup>

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35. *Id.* at \*3.

36. *Id.*

37. *Id.* at \*1–2; *see also* Shane Exchange Act Release, 2005 SEC LEXIS 1390, at \*5.

38. Short Selling in Connection with a Public Offering, Exchange Act Release No. 54888, 71 Fed. Reg. 75002, 75004 (Dec. 13, 2006) (proposed Dec. 6, 2006) (to be codified at 17 C.F.R. pt. 242). The SEC noted:

The first time an issuer conducts a public offering of its securities, the offering is referred to as an initial public offering (“IPO”). Subsequent offerings by the issuer are referred to as follow-on offerings or repeat offerings. A secondary offering is an offering of securities held by security holders, for which there already exist trading markets for the same class of securities as those being offered.

*Id.* at 75003 n.12.

39. 17 C.F.R. § 242.105 (2007).

40. Short Selling in Connection with a Public Offering, 71 Fed. Reg. at 75003.

41. 17 C.F.R. § 242.105; Short Selling in Connection with a Public Offering, Exchange Act Release No. 56206, 73 Fed. Reg. 45,094 (Aug. 10, 2007).

The SEC has charged several hedge funds with violating Rule 105. In October 2007, for example, the SEC brought a case against Colonial Investment Management LLC, Colonial Fund LLC and Cary G. Brody, alleging that the defendants realized \$1.48 million in ill-gotten gains by violating Rule 105 in connection with eighteen public offerings.<sup>42</sup> The SEC alleged that in ten of those trades, Colonial engaged in conduct calculated to conceal the use of the offering stock to cover the short sales.<sup>43</sup> After receiving the offering stock and using it to cover its short positions, Colonial bought and sold stock in the same company through open market purchases, directing the executive broker to purchase and sell the same number of shares it was short at the same price.<sup>44</sup> The SEC's complaint alleged that the open market purchases and sales were essentially shams, and that the fund used the offering shares as the actual covers.<sup>45</sup> The complaint sought full disgorgement and prejudgment interest from all three defendants and a civil penalty from Brody.<sup>46</sup>

In June 2007, the SEC brought a sizeable Rule 105 case against British hedge fund manager GLG Partners, LP, an adviser for thirty hedge funds with aggregate assets of over \$12 billion.<sup>47</sup> In an administrative proceeding, the SEC found that GLG Partners had violated Rule 105 between 2003 and 2005 in connection with fourteen offerings through trades involving four of GLG Partners' funds.<sup>48</sup> In settling the SEC's charges, GLG Partners agreed to disgorge approximately \$2.2 million in allegedly ill-gotten gains, pay a \$500,000 civil penalty, and implement policies and procedures specifically to prevent violations of Rule 105.<sup>49</sup>

In March 2007, the SEC charged Imperium Advisors, LLC, a hedge fund adviser, with violating Rule 105.<sup>50</sup> The conduct, according to the SEC's administrative order, was straightforward in that there were no allegations of open market purchases, but instead simple allegations that the fund used offering stock to cover the restricted period short sales.<sup>51</sup> The fund settled for a cease-and-desist

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42. SEC v. Colonial Inv. Mgmt. LLC, Litigation Release No. 20332, 2007 SEC LEXIS 2428 (Oct. 15, 2007), available at <http://www.sec.gov/litigation/litreleases/2007/lr20332.htm>; Complaint at 7-15, SEC v. Colonial Inv. Mgmt. LLC, No. 07 Civ. 8849 (S.D.N.Y. Oct. 15, 2007).

43. Complaint at 10-15, SEC v. Colonial Inv. Mgmt. LLC, No. 07 Civ. 8849 (S.D.N.Y. Oct. 15, 2007).

44. *Id.*

45. *Id.*

46. *Colonial Inv. Mgmt.*, 2007 SEC LEXIS 2428.

47. *In re* GLG Partners, LP, Exchange Act Release No. 55956, 2007 SEC LEXIS 1372 (June 26, 2007), available at <http://www.sec.gov/litigation/admin/2007/34-55956.pdf>.

48. *Id.* at \*2-3.

49. *Id.* at \*8-9.

50. *In re* Imperium Advisors, LLC, Exchange Act Release No. 55483A, Investment Advisers Act Release No. 2597A, 2007 SEC LEXIS 504 (Mar. 15, 2007), available at <http://www.sec.gov/litigation/admin/2007/34-55483a.pdf>.

51. *Id.* at \*2.

order, agreed to disgorge \$75,192 plus prejudgment interest of \$7,176, and agreed to pay a civil penalty of \$37,596—equivalent to one-half of the disgorgement sum.<sup>52</sup>

#### *D. Other Short Sale Cases*

The Commission generally is concerned where short selling can serve as a tool for manipulating the price of a stock. For example, in April 2006, the Commission alleged that six individuals acting for an unregistered investment adviser, Rhino Advisors, Inc., engaged in manipulative short selling of Sedona Corporation stock.<sup>53</sup> The SEC alleged that the defendants “used short selling to manipulate Sedona’s stock price downward to enhance a client’s economic interest in an agreement with Sedona.”<sup>54</sup> Specifically, the complaint stated that the client entered into an agreement with Sedona pursuant to which the client loaned Sedona \$2.5 million in exchange for Sedona’s pledge to pay the client \$3 million several months later.<sup>55</sup> The client was to convert Sedona’s debt into Sedona common stock at a discount based on Sedona’s stock price.<sup>56</sup> The lower Sedona’s stock price, the more the client would benefit.<sup>57</sup> The client’s agreement with Sedona specifically precluded the client from short selling Sedona’s stock.<sup>58</sup> The Commission’s complaint alleged that the traders nevertheless sold short Sedona’s stock on behalf of the client, sending Sedona’s stock price down and ultimately benefiting the client.<sup>59</sup>

#### *E. Information Barriers and Trading Restrictions*

Related to insider trading are cases involving information barriers. Broker-dealers set up information barriers between different business units and employees generally because they are required to have policies and procedures in place to prevent the dissemination of material nonpublic information under Exchange Act Section 15(f).<sup>60</sup> Other financial institutions might establish information barriers to avoid insider trading exposure when one unit of the firm legitimately receives material nonpublic information about a particular issuer under a duty of confidentiality, and another unit of the firm wants to trade in the

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52. *Id.* at \*8.

53. SEC v. Badian, Litigation Release No. 19639, 2006 SEC LEXIS 757 (Apr. 4, 2006), *available at* <http://www.sec.gov/litigation/litreleases/2006/lr19639.htm>; Complaint, SEC v. Badian, No. 06 Civ. 2621 (S.D.N.Y. Apr. 4, 2006).

54. *Id.* at \*1.

55. Complaint at 1–2, SEC v. Badian, No. 06 Civ. 2621 (S.D.N.Y. Apr. 4, 2006).

56. *Id.*

57. *Id.*

58. *Id.*

59. *Id.* at ¶ 2.

60. 15 U.S.C. §78o(f) (2000).

securities of the same issuer. SEC Rule 10b5-1<sup>61</sup> creates a defense for entities to insider trading liability when effective information barriers exist and the individuals who trade are not aware of the material nonpublic information held by others at the firm. Depending on the particular circumstances, information barriers might be a solution for hedge fund advisers when, for example:

- One fund in a hedge fund complex invests in distressed debt and finds itself on creditors committees or otherwise obtains material nonpublic information about issuers, but other funds in the same complex desire to continue trading securities in the same issuers.
- Designated personnel within a hedge fund complex receive solicitations to invest in PIPE transactions and agree to keep the fact of the potential PIPE confidential, but certain funds in the complex own the stock and seek to avoid trading restrictions.

Although the SEC does not yet appear to have brought a case against a hedge fund specifically involving inadequate information barriers, it recently has brought cases against broker-dealers concerning information barriers. A November 2005 SEC enforcement action, *In re Van D. Greenfield*, illustrates the type of information barrier issues that might arise with hedge fund advisers.<sup>62</sup> In that case, the SEC brought a settled enforcement action charging a broker-dealer, Blue River Capital LLC, and its principal, Greenfield, with lacking adequate procedures to prevent the dissemination of material nonpublic information in violation of Exchange Act Section 15(f).<sup>63</sup> Blue River served as a member of either the creditors committee or the equity securities committee in the bankruptcies of public issuers including Globalstar, Adelphia, and WorldCom.<sup>64</sup> Through its membership on these committees, Blue River came into possession of material nonpublic information that it had a duty to keep confidential.<sup>65</sup>

The Commission perceived several information barrier deficiencies. First, it considered the barriers porous: Although Greenfield handed over trading in these stocks to another Blue River staff member, Greenfield continued to ask trading room staff about Adelphia and WorldCom, to discuss Globalstar with a securities analyst that covered the stock, and to receive “daily Blue River profit and loss reports . . . that reflected Blue River’s trading activity in Globalstar, Adelphia, and WorldCom securities.”<sup>66</sup> Second, Blue River lacked written guidelines or procedures to prevent the misuse by Blue River of material nonpublic informa-

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61. 17 C.F.R. §240.10b5-1 (2007).

62. *In re Van D. Greenfield*, Exchange Act Release No. 52744, 2005 SEC LEXIS 2892 (Nov. 7, 2005), available at <http://www.sec.gov/litigation/admin/34-52744.pdf>.

63. *Id.*

64. *Id.* at \*3-5.

65. *Id.* at \*6.

66. *Id.* at \*8-10.

tion obtained by Greenfield and did not restrict Blue River's trading in Adelphia, WorldCom, and Globalstar.<sup>67</sup> Finally, there was no surveillance: No one at Blue River "monitored for compliance purposes any aspect of Blue River's trading" in Adelphia, WorldCom, and Globalstar.<sup>68</sup>

Where an information barrier might not work, and certain funds in a complex have material nonpublic information about an issuer, placing the stock on a restricted list often becomes the appropriate solution. Here, too, the SEC does not appear to have brought cases directly against hedge funds specifically for failures in establishing or policing restricted lists. But, the SEC has brought cases against broker-dealers involving those issues. In *In re Morgan Stanley & Co.*, the existence of computer glitches allegedly meant that there was no surveillance concerning watch list securities by certain accounts for several years.<sup>69</sup> Morgan Stanley settled an administrative proceeding by agreeing, among other things, to pay a \$10 million civil penalty and to cease-and-desist from further violations of Exchange Act Section 15(f).<sup>70</sup>

#### F. Late Trading and Market Timing Cases Involving Hedge Funds

As in prior years, 2007 saw a significant number of late trading and market timing cases involving hedge funds. The U.S. Attorney for the Eastern District of Pennsylvania brought the first criminal case against a hedge fund for deceptive market timing in charging Beacon Rock Capital, LLC.<sup>71</sup> The information charged that Thomas Gerbasio, a registered representative of two broker-dealers, helped Beacon Rock conceal its identity and the nature of its trades in order to engage in market timing trades and circumvent controls implemented by mutual funds seeking to restrict market timing or other excessive trading.<sup>72</sup> The SEC filed a parallel civil injunctive action, alleging the following techniques to evade mutual fund restrictions on market timing: "misrepresenting the nature of their trades to the funds, opening dozens of accounts under different names to conceal the customers' identities from the funds, entering trades in amounts designed to avoid the funds' detection triggers, [and] trading in funds where management was less likely to detect market timing."<sup>73</sup> Gerbasio settled the SEC action by

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67. *Id.* at \*10.

68. *Id.*

69. *In re Morgan Stanley & Co.*, Exchange Act Release No. 54047, Investment Advisers Act Release No. 2526, 2006 SEC LEXIS 1465 (June 27, 2006), *available at* <http://www.sec.gov/litigation/admin/2006/34-54047.pdf>.

70. *Id.*; *see also* SEC v. Barclays Bank PLC, Litigation Release No. 20132, 2007 SEC LEXIS 1170 (May 30, 2007), *available at* <http://www.sec.gov/litigation/litreleases/2007/lr20132.htm> (concerning information barriers and restricted lists by broker-dealers).

71. U.S. v. Beacon Rock Capital, LLC, Litigation Release No. 20051, 2007 SEC LEXIS 552 (Mar. 22, 2007), *available at* <http://www.sec.gov/litigation/litreleases/2007/lr20051.htm>.

72. *Id.*

73. *Id.* at \*3.

consenting to an injunction against violating Exchange Act Section 10(b) and agreeing to pay \$540,044 in disgorgement and prejudgment interest, later waived down to \$100,000.<sup>74</sup> The court did not impose a civil penalty, based on Gerbasio's sworn financial statements to the Commission that he lacked the financial resources to pay.<sup>75</sup> In a follow-on administrative proceeding, the Commission barred Gerbasio from association with broker-dealers.<sup>76</sup> In the criminal matter, Beacon Rock entered a guilty plea.<sup>77</sup>

In *SEC v. Fife*, the SEC charged a hedge fund adviser, Clarion Management, and its principal, John Fife, with engaging in market timing by purchasing variable annuity contracts and by "using trusts and limited liability companies as nominee contract owners and beneficiaries to conceal Clarion Capital's financial interest in the variable annuity contracts."<sup>78</sup> The complaint charged Fife and Clarion with violating Exchange Act Section 10(b) and Rule 10b-5, and Fife with control person liability under Exchange Act Section 20(a).<sup>79</sup>

In the last several years, the SEC has brought important enforcement actions against hedge funds or their personnel regarding market timing or late trading. In December 2005, the SEC brought an administrative proceeding against Veras Capital Master Fund, VEY Partners Master Fund, Veras Investment Partners, LLC, Kevin D. Larson, and James R. McBride (the "Veras Respondents") for late trading and market timing.<sup>80</sup> The settlement required that the respondents pay over \$35 million in disgorgement and \$750,000 in penalties, and imposed eighteen-month industry bars for each of the individuals.<sup>81</sup> The Commission found that Veras used several manipulative devices in order to engage in market timing and late trading while avoiding detection.<sup>82</sup> The Com-

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74. *Id.* at \*3-4.

75. *See id.* at \*4.

76. *Id.*

77. *See* Christine Caulfield, *Hedge Fund to Plead Guilty to Market Timing*, SEC. L. 360, Mar. 28, 2007.

78. *SEC v. Fife*, Litigation Release No. 19972, 2007 SEC LEXIS 107 (Jan. 19, 2007), *available at* <http://www.sec.gov/litigation/litreleases/2007/lr19972.htm>.

79. *Id.*

80. *In re Veras Capital Master Fund*, Securities Act Release No. 8646, Exchange Act Release No. 53011, Investment Company Act Release No. 27197, Investment Advisers Act Release No. 2466, 2005 SEC LEXIS 3290 (Dec. 22, 2005), *available at* <http://www.sec.gov/litigation/admin/33-8646.pdf>.

81. Press Release, SEC, SEC Charges Veras Capital Master Fund, VEY Partners Master Fund, Veras Investment Partners, LLC, Kevin D. Larson, and James R. McBride in Fraudulent Market Timing and Late Trading Scheme (Dec. 22, 2005), *available at* <http://www.sec.gov/news/press/2005-182.htm>.

82. *Veras Capital Master Fund*, 2005 SEC LEXIS 3290, at ¶¶ 11-12.

One such deceptive technique was the creation of legal entities with names unrelated to 'Veras.' . . . During the relevant time, Respondents used these entities to open multiple accounts at multiple broker dealers. Respondents traded through these accounts to, among other things, evade the restrictions imposed by the mutual funds on trading. Respondents also used the multiple accounts to divide trades into smaller dollar amounts that would more likely evade detection by the mutual funds.

mission's order noted that the Veras Respondents also engaged in late trading by trading mutual fund shares after 4:00 p.m. eastern time and receiving the same day's price.<sup>83</sup> The Commission found that the Veras Respondents violated, and willfully aided and abetted others' violations of, the antifraud provisions of the federal securities laws, and willfully aided and abetted violations under the Investment Company Act of 1940.<sup>84</sup> In addition to disgorgement and penalties, the Veras Respondents consented to the entry of a fraud cease-and-desist order and are required to continue cooperating with the Commission.<sup>85</sup>

The SEC has brought numerous enforcement actions against mutual funds for allowing hedge funds or their personnel to engage in market timing or late trading. For example, in October 2004, the SEC filed an administrative proceeding against Invesco Funds Group, Inc. ("IFG"), AIM Advisors, Inc., and AIM Distributors, Inc., for allowing certain customers—some of whom were hedge funds, including Canary Capital Partners LLC—to engage in market timing in Invesco Funds advised by IFG and AIM Mutual Funds advised by AIM Advisors.<sup>86</sup> The SEC alleged that "IFG entered into negotiated, but undisclosed, market timing agreements with over 40 individuals and entities . . . which allowed them to 'market time' certain Invesco Funds, while representing to other shareholders that it did not permit frequent trading in those funds," and in addition allowed market timing by other shareholders with whom it did not have such agreements.<sup>87</sup> IFG was alleged to have benefited by realizing increased advisory fees as a result of the market timing, a failure to disclose a conflict of interest based on the market timing, which the SEC described as "detrimental" to the Invesco Funds, and a resulting fiduciary duty to the Invesco Funds and public shareholders of the mutual funds.<sup>88</sup> Similarly, the SEC alleged that AIM advisers entered into market timing agreements with ten individual entities, resulting in higher fees, giving rise to potential conflicts of interest and a breach in fiduciary duty to the AIM Funds and shareholders.<sup>89</sup> AIM Advisors and AIM Distributors were ordered to disgorge \$20 million, AIM Advisors was ordered to pay a civil penalty of \$25 million, and AIM Distributors was ordered

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*Id.*

83. *Id.* at ¶¶ 15–16.

84. *Id.* at ¶¶ 18–20.

85. *Id.* § IV.A.

86. *In re* Invesco Funds Group, Exchange Act Release No. 50506, Investment Advisers Act Release No. 2311, Investment Company Act Release No. 26629, 2004 SEC LEXIS 2318 (Oct. 8, 2004), available at <http://www.sec.gov/litigation/admin/34-50506.htm>.

87. *Id.*

88. *Id.*

89. *Id.*

to pay a civil penalty of \$5 million; IFG was ordered to pay disgorgement of \$215 million and a civil penalty of \$110 million.<sup>90</sup>

### G. *Conflict of Interest Cases*

Some SEC enforcement matters involve allegations that hedge fund advisers, due to conflicts of interest, have disadvantaged investment advisory clients. In an administrative proceeding, the Division of Enforcement charged that, from 2001 through 2003, George Motz, the president and chief executive officer (“CEO”) of Melhado, Flynn & Associates, Inc. (“MFA”), “engaged in fraudulent trade allocation—‘cherry-picking’—at MFA,” an investment adviser and registered broker-dealer.<sup>91</sup> “Motz unfairly allocated trades that had appreciated in value during the course of the day to MFA’s proprietary trading account and allocated purchases that had depreciated in value during the day to the accounts of his advisory clients.”<sup>92</sup> Beginning in the summer of 2003, according to the Order Instituting Proceedings (“OIP”),<sup>93</sup> “Motz engaged in cherry-picking to favor one of the firm’s advisory clients, a hedge fund affiliated with MFA, over his other advisory clients.”<sup>94</sup> “Motz accomplished this cherry-picking by purchasing securities toward the beginning of the trading day but waiting until later in the day—after he saw whether the securities appreciated in value—to allocate the securities.”<sup>95</sup> “[N]early every trade that Motz allocated to MFA’s proprietary account during [the relevant] period had appreciated in value from the time it was purchased earlier in the day” resulting in “a net gain of close to \$1.4 million.”<sup>96</sup> According to the OIP, “[n]either MFA nor Motz disclosed to clients that the firm was engaged in cherry-picking and that the firm would favor itself in the allocation of appreciated securities. Nor did MFA or Motz disclose to clients that the firm engaged in cherry-picking to favor Third Millennium over other

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90. *Id.*

91. *In re Melhado, Flynn & Assocs., Inc.*, Exchange Act Release No. 55356, Investment Advisers Act Release No. 2593, 2007 SEC LEXIS 372 (Feb. 26, 2007), *available at* <http://www.sec.gov/litigation/admin/2007/34-55356-o.pdf>.

92. *Id.* at \*1.

93. An OIP is an order issued by the Commission—generally after investigation and notice and opportunity for hearing—that lays out the Commission’s findings and orders any respondent to cease and desist from current and future violations of the same provision, rule, or regulation the respondent is charged with violating. The OIP may also require undertakings, such as undertakings to cooperate with Commission staff in further investigation or to retain special consultants to monitor compliance or develop programs. An OIP may also order civil money penalties to be paid to the Commission. *See generally* Securities Act of 1933 § 8A, 15 U.S.C. 77h-1 (2006); Securities Exchange Act of 1934 § 21, 15 U.S.C. §§ 78u-3, 78u(a)(3) (2006).

94. *Melhado, Flynn & Assocs.*, 2007 SEC LEXIS 372, at \*8.

95. *Id.* at \*4.

96. *Id.* at \*9.

advisory clients.”<sup>97</sup> The SEC further alleged that Motz and MFA falsified documents to conceal their activities from SEC examiners.<sup>98</sup>

#### *H. Misappropriating Assets and Similar Misrepresentations*

The SEC historically has filed cases involving misappropriation or other conduct when hedge fund advisers allegedly victimized their advisory clients. For example, in September 2005, in the wake of widespread media reports of apparent fraud at a Connecticut-based hedge fund, the Commission alleged that Samuel Israel III and Daniel E. Marino, managers of the Bayou Funds, defrauded investors by “grossly exaggerating the Funds’ performance to make it appear that the Funds were profitable and attractive investments, when in fact, the Funds had never posted a year-end profit.”<sup>99</sup> The Commission’s complaint further alleged that Bayou, Israel, and Marino had misappropriated millions of dollars of investor funds and had mostly stopped trading for the Funds altogether, but still sent periodic and financial statements to investors, indicating that their strategy was profitable.<sup>100</sup> In April 2006, Israel and Marino consented to permanent injunctions against future violations of Securities Act Section 17(a), Exchange Act Section 10(b) and Rule 10b-5, and Advisers Act Sections 206(1) and (2).<sup>101</sup> The judgment allowed the SEC to continue to seek monetary remedies against Israel and Marino.<sup>102</sup> In related administrative proceedings, the Commission barred Israel and Marino from association with broker-dealers and investment advisers.<sup>103</sup>

Just two weeks after filing the Bayou Management case, in October 2005, the Commission filed an emergency civil action against John H. Whittier, Wood River Capital Management, LLC, Wood River Associates, LLC, Wood River Partners, LP, and Wood River Partners Offshore, Ltd., for purported violations of the anti-fraud provisions of the federal securities laws.<sup>104</sup> The Commission’s complaint alleged that Whittier made “material misrepresentations in fund offering materials, in marketing materials and in discussions with numerous investors.”<sup>105</sup> The Commission alleged that the defendants had promised investors

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97. *Id.* at \*8–9.

98. *Id.* at \*2.

99. SEC v. Samuel Israel III, Litigation Release No. 19406, 2005 SEC LEXIS 2463 (Sept. 29, 2005), available at <http://www.sec.gov/litigation/litreleases/lr19406.htm>.

100. *Id.*

101. *In re* Samuel Israel III, Litigation Release No. 19692, Exchange Act Release No. 53775, 2006 SEC LEXIS 1040 (May 9, 2006), available at <http://www.sec.gov/litigation/litreleases/2006/lr19692.htm>.

102. *Id.*

103. *Id.*

104. SEC v. Wood River Capital Mgmt., LLC, Litigation Release No. 19428, 2005 SEC LEXIS 2647 (Oct. 13, 2005), available at <http://sec.gov/litigation/litreleases/lr19428.htm>.

105. Complaint at 5, ¶ 15, SEC v. Wood River Capital Mgmt., No. 05-CIV-8713 (S.D.N.Y. Oct. 13, 2005).

that the Funds would be diversified and audited.<sup>106</sup> In reality, the Funds were never audited, and more than 65 percent of the Funds' assets were invested in one small-cap company, the value of which ultimately declined, exposing the Funds to large losses.<sup>107</sup> The defendants consented to preliminary injunctions and asset freezes.<sup>108</sup>

In February 2006, the Commission filed an emergency action to "halt an ongoing offering fraud involving the sale of investments in seven hedge funds" by Kirk S. Wright and two investment advisers.<sup>109</sup> The complaint alleged that over the course of nine years, Wright raised at least \$115 million from as many as five hundred investors and provided investors with "quarterly statements that misrepresented both the amount of assets in the respective funds and the rates of return obtained by them."<sup>110</sup> On February 9, 2007, the court entered a default judgment enjoining Wright from future violations of Sections 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and from future violations of, or aiding and abetting violations of, Sections 206(1) and 206(2) of the Advisers Act.<sup>111</sup> "The court also ordered disgorgement against Wright in the amount of \$17,019,510 with prejudgment interest in the amount of \$2,786,399, and imposed a civil penalty of \$120,000."<sup>112</sup> In March 2007, the SEC instituted an administrative proceeding against Wright pursuant to Section 203(f) of the Advisers Act.<sup>113</sup>

Finally, in an administrative action instituted in March 2006, the SEC Enforcement Division alleged that Rani T. Jarkas and Antoine K. Chaya, the managers of Global Crown Capital, LLC of J&C Global Securities Investments, LLC ("J&C"), exaggerated the Fund's performance in order to conceal trading losses from the Fund's investors.<sup>114</sup> The Division claimed that Jarkas and Chaya sent misleading account statements to investors that falsely inflated the Fund's performance and understated the Fund's losses by nearly 90 percent.<sup>115</sup> The Division of Enforcement, however, moved to dismiss this action in October 2006

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106. *Wood River Capital Mgmt.*, 2005 SEC LEXIS 2647, at \*1.

107. *Id.* at \*1-2.

108. *Id.* at \*3.

109. SEC v. Kirk S. Wright, Litigation Release No. 19581, 2006 SEC LEXIS 465, \*1 (Feb. 28, 2006), *available at* <http://www.sec.gov/litigation/litreleases/lr19581.htm>.

110. *Id.* at \*1-2.

111. SEC v. Kirk S. Wright, Litigation Release No. 19999, 2007 SEC LEXIS 276 (Feb. 12, 2007), *available at* <http://www.sec.gov/litigation/litreleases/2007/lr19999.htm>.

112. *Id.* at \*1.

113. *In re* Kirk S. Wright, Investment Advisers Act Release No. 2595, 2007 SEC LEXIS 422 (Mar. 2, 2007), *available at* <http://www.sec.gov/litigation/admin/2007/ia-2595.pdf>.

114. *In re* Global Crown Capital, LLC, Exchange Act Release No. 53569, Investment Advisers Act Release No. 2503, 2006 SEC LEXIS 733 (Mar. 30, 2006), *available at* <http://www.sec.gov/litigation/admin/ia-2503-o.pdf>.

115. *Id.*

“in light of the potential impact of the recent decision by the District of Columbia Circuit in *Goldstein v. SEC*, on the validity of claims against these Respondents under Sections 206(1) and 206(2) of the Advisers Act.”<sup>116</sup> The action was dismissed on February 20, 2007.<sup>117</sup>

### *I. Cases Involving Broker-Dealers*

The SEC and the self-regulatory organizations (“SROs”) have focused on the role of broker-dealers as gatekeepers for their hedge fund clients. In a March 2007 speech, Linda Chatman Thomsen said that broker-dealers that aid and abet or cause violations have regulatory exposure, reasoning that by virtue of their relationship with hedge funds, broker-dealers sometimes have a window into misconduct by those customers.<sup>118</sup> Thomsen queried whether broker-dealers would allow certain customer conduct if those customers were not so lucrative for them, and cautioned broker-dealers that they should apply to institutional customers the same standards they apply to retail customers when deciding whether to report violations.<sup>119</sup>

In a recent civil action, Zurich Capital Management (“ZCM”) settled for over \$16 million in disgorgement and penalties after being charged with aiding and abetting four hedge funds in alleged market timing schemes.<sup>120</sup> ZCM allegedly provided the hedge funds with the financing needed to execute their transactions despite knowing they were engaged in market timing tactics.<sup>121</sup> In addition to financing their actions, ZCM further facilitated the schemes by setting up anonymous special purpose vehicles, which effectively allowed the funds to mask their identities as they executed the prohibited trades.<sup>122</sup>

In March 2007, the SEC charged Goldman Sachs Execution and Clearing, LP (“Goldman”) for allegedly allowing a customer improperly to mark orders long when they were short, thereby violating Exchange Act Section 10(a) and Rule 10a-1(d), when Goldman neither carried the securities in the relevant accounts nor received assurances from the customer that it would deliver the securities.<sup>123</sup> The trades took place through Goldman’s direct-access trading system.<sup>124</sup>

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116. *In re* Global Crown Capital, LLC, Exchange Act Release No. 55318, Investment Advisers Act Release No. 2591, 2007 SEC LEXIS 335 (Feb. 20, 2007), available at <http://www.sec.gov/litigation/admin/2007/34-56075.pdf>.

117. *Id.*

118. See Remarks Before the IA Week, *supra* note 5.

119. *Id.*

120. *In re* Zurich Capital Mkts. Inc., Exchange Act Release No. 55711, Investment Company Act Release No. 27819, 2007 SEC LEXIS 943 (May 7, 2007), available at <http://www.sec.gov/litigation/admin/2007/34-55711.pdf>.

121. *Id.* at \*2.

122. *Id.* at \*6.

123. *In re* Goldman Sachs Execution & Clearing, LP, Exchange Act Release No. 55465, 2007 SEC LEXIS 491 (Mar. 14, 2007), available at <http://www.sec.gov/litigation/admin/2007/34-55465.pdf>.

The Commission found that Goldman possessed information suggesting that the selling customers were misrepresenting their sales, including records revealing the selling customers were repeatedly failing to deliver the securities that they purported to sell long, confirmations from the brokers from whom the selling customers had purchased cover stock indicating the purchases made were related to short sales, and Clearance Activity Reports, Daily Margin Reports, and Daily Stock Records showing that the selling customers held short positions in the offered securities.<sup>125</sup>

### *J. Other Regulatory Actions*

In addition to actions brought against hedge funds for alleged malfeasance directly affecting the markets and/or investors, the SEC staff has targeted hedge funds in various proceedings alleging failure to meet regulatory reporting and other requirements. For example, in August 2007, the staff settled with Quattro Global Capital, LLC (“Quattro”), a registered investment adviser to a group of hedge funds.<sup>126</sup> Quattro had assets of approximately \$900 million under management.<sup>127</sup> “Section 13(f) of the Exchange Act and Rule 13f-1 thereunder require institutional investment managers who exercise investment discretion over \$100 million or more of Section 13(f) securities . . . to file Forms 13F quarterly with the Commission” disclosing the Section 13(f) securities under the manager’s discretion.<sup>128</sup> The purpose of this requirement is to create a central repository of the activities of investment managers to “facilitate consideration of the influence and impact of institutional investment managers on the securities markets and the public policy implications of that influence.”<sup>129</sup> The staff alleged that Quattro repeatedly and willfully failed to meet its statutory obligation to file Form 13F reports over a period of more than three years.<sup>130</sup> Quattro was ordered to cease and desist such violations and to pay a civil money penalty of \$100,000.<sup>131</sup>

This case is notable in light of recent attempts by hedge fund managers, who tend to be notoriously secretive about their fund portfolios, to challenge the SEC’s

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124. *Id.* at \*2.

125. *Id.* at \*9–12.

126. *See In re Quattro Global Capital, LLC*, Exchange Act Release No. 56252, Investment Advisers Act Release No. 2634, 2007 SEC LEXIS 1807 (Aug. 15, 2007), *available at* <http://www.sec.gov/litigation/admin/2007/34-56252.pdf>.

127. *Id.*

128. *Id.* at \*2. Generally, Section 13(f) securities are “exchange-traded equities (including certain convertible debt securities) . . .” *Id.*

129. Reporting by Institutional Investment Managers of Information With Respect To Accounts Over Which Investment Discretion is Exercised, Exchange Act Release No. 13396, 1977 SEC LEXIS 2137, at \*3–4 (Mar. 22, 1977).

130. *Quattro Global Capital*, 2007 SEC LEXIS 1946 at \*8.

131. *Id.* at \*9.

right to any information at all about their holdings. On October 24, 2006, Philip Goldstein, the manager who successfully challenged the SEC's hedge fund adviser registration requirement, filed for exemption from the 13F filing requirement, claiming that Rule 13f-1 violates the Fifth Amendment of the U.S. Constitution by allowing the SEC to take private property for public use "without just compensation."<sup>132</sup> Goldstein also argued that Rule 13f-1 serves no legitimate regulatory purpose and is, in fact, detrimental to hedge fund advisers, in that forcing the adviser to publicly identify portfolio holdings is tantamount to requiring the publication of trade secrets.<sup>133</sup> As of the date of this article, no official action has been taken on Goldstein's application, and the Quattro action is at least one indication that the SEC remains unsympathetic to Goldstein's claims.

### III. ISSUES RAISED DURING SEC EXAMINATIONS

SEC enforcement actions are one indicator of the SEC's current priorities regarding hedge funds. While hedge fund advisers may or may not be registered with the SEC,<sup>134</sup> issues raised by regulators in the course of SEC examinations of registered investment advisers also indicate important areas of focus for all hedge fund advisers and compliance personnel.<sup>135</sup> Understanding these issues, and devoting appropriate time and resources to addressing them, may prevent compliance problems from developing into enforcement actions.<sup>136</sup>

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132. *In re Full Value Advisers, LLC*, Application for an Order Pursuant to 13(f)(2) of the Exchange Act for Exemption from Rule 13f-1 (Oct. 24, 2006), available at [http://www.pomtalk.com/pomtalk/files/request\\_for\\_exemption\\_from\\_rule\\_13f1.pdf](http://www.pomtalk.com/pomtalk/files/request_for_exemption_from_rule_13f1.pdf).

133. *Id.*

134. All hedge fund advisers meet the definition of "investment adviser" under the Advisers Act and are therefore within the SEC's enforcement jurisdiction. Typically, however, a hedge fund adviser is not required to register if it advises fewer than fifteen funds and other clients within a twelve month period (although an adviser may elect to register for business or other reasons). See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004) (to be codified 17 C.F.R. pt. 275, 278), available at <http://www.sec.gov/rules/final/ia-2333.htm>.

135. Much of the information set forth in Part III is based on the authors' experience with adviser clients that have undergone SEC examinations. For publicly published information regarding the SEC examination process, see, for example, SEC, EXAMINATION INFORMATION FOR BROKER-DEALERS, TRANSFER AGENTS, CLEARING AGENCIES, INVESTMENT ADVISERS, AND INVESTMENT COMPANIES, available at [http://www.sec.gov/about/offices/ocie/ocie\\_exam brochure.pdf](http://www.sec.gov/about/offices/ocie/ocie_exam brochure.pdf) [hereinafter EXAMINATION INFORMATION]; Lori A. Richards, Dir., Office of Compliance Inspections and Examinations, SEC, SEC's Compliance Examinations in the Protection of Investors, Remarks at the 9th Annual IA Compliance Best Practices Summit 2007, IA Week and the Investment Adviser Association (Mar. 23, 2007), available at <http://www.sec.gov/news/speech/2007/spch032307lar.htm> [hereinafter SEC's Compliance Examinations]; SEC, QUESTIONS ADVISERS SHOULD ASK WHILE ESTABLISHING OR REVIEWING THEIR COMPLIANCE PROGRAMS (2006), [http://www.sec.gov/info/cco/adviser\\_compliance\\_questions.htm](http://www.sec.gov/info/cco/adviser_compliance_questions.htm) [hereinafter QUESTIONS ADVISERS SHOULD ASK].

136. Since the adoption of Rule 206(4)-7, advisers have focused with increasing specificity on compliance issues and problems, particularly as they relate to the adviser's potential conflicts of interest. In September 2007, ACA Compliance Group, the Investment Adviser Association, IM Insight, and Old Mutual Asset Management issued a detailed report analyzing the results of their spring 2007 survey on investment manage-

Registered hedge fund advisers are subject to routine periodic examinations by the SEC's Office of Compliance Inspections and Examinations ("OCIE") and Division of Investment Management inspection programs.<sup>137</sup> Since February 2004, all registered investment advisers are required by Rule 206(4)-7 under the Advisers Act to designate a chief compliance officer ("CCO") and to adopt a comprehensive compliance program that is reasonably designed to prevent, detect, and correct violations of the federal securities laws.<sup>138</sup> OCIE inspections involve a top-to-bottom audit of advisers' operations and compliance programs, and can sometimes reveal deficiencies that might otherwise go undetected. SEC officials have repeatedly underscored the need for hedge fund advisers to assess potential risks and conflicts of interest, and address them in written policies and procedures that are tailored to the adviser's business.<sup>139</sup> The areas of recent SEC examination focus are detailed in the following subsections.

### *A. Conflicts and Risk Assessment*

As a fundamental principle, SEC examiners look for a strong "culture of compliance," including an obvious "tone from the top."<sup>140</sup> CCOs must be sufficiently empowered, experienced, competent, and compensated, and must have sufficient and obvious access to the CEO, chief financial officer, and other critical decision makers.<sup>141</sup> In addition, SEC officials have stated that a compliance program is by definition deficient if it does not start with a realistic, systematic, and written assessment of conflicts and solutions.<sup>142</sup> Examiners expect to see a com-

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ment compliance testing practices. The report summarized responses from more than 450 chief compliance officers and other adviser compliance professionals and indicates how advisers have sought to comply with the Commission's compliance requirements under Rule 206(4)-7. Specific areas of increasing focus include personal trading, receipt and provision of gifts and entertainment, political and charitable contributions, and insider trading. ACA COMPLIANCE GROUP ET AL., 2007 INVESTMENT MANAGEMENT COMPLIANCE TESTING SURVEY (2007), *available at* <http://www.investmentadviser.org/public/2007%20IM%20Testing%20Report.pdf>.

137. EXAMINATION INFORMATION *supra* note 135.

138. Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299, Investment Advisers Act Release No. 2204, 2003 SEC LEXIS 2980, \*4-5 (Dec. 17, 2003) (rules became effective Feb. 5, 2004).

139. *See, e.g.*, Gene Gohlke, Assoc. Dir., Office of Compliance Inspections and Examinations, SEC, Remarks before the Fund of Funds Forum (Nov. 14, 2005), *available at* <http://www.sec.gov/news/speech/spch111405gag.htm> [hereinafter Remarks before the Fund of Funds].

140. *See, e.g.*, SEC's Compliance Examinations, *supra* note 135.

141. Gene Gohlke, Assoc. Dir., Office of Compliance Inspections and Examinations, SEC, Managed Funds Association Educational Seminar Series 2005: Practical Guidance for Hedge Fund CCOs Under the SEC's New Regulatory Framework (May 5, 2005), *available at* <http://sec.gov/news/speech/spch050505gg.htm> ("[T]he compliance officer should have a position of sufficient seniority and authority within the organization to be able to compel others to adhere to the firm's compliance policies and procedures.").

142. *See generally* QUESTIONS ADVISERS SHOULD ASK, *supra* note 135 (asserting that a "risk assessment" analysis should be conducted during the initial establishment of the compliance program and periodically thereafter).

prehensive “risk map,” which identifies conflicts and other areas of challenge and clearly discloses responsibilities and lines of reporting.<sup>143</sup>

*B. Acquisition and Sharing of Information*

*1. Information Barriers*

Hedge funds that engage in multiple strategies may find that certain individuals receive material nonpublic information in the context of one type of investment that would restrict the fund’s implementation of its strategy. For example, a portfolio manager for a fund that invests in corporate loans to distressed issuers may receive nonpublic information about the issuer in connection with those loans. Another portfolio manager may independently compile information that supports an investment decision to short the equity of that issuer, but once the adviser is in possession of material nonpublic information on the loan side, investments in all of that issuer’s securities must be restricted unless the adviser erects an information barrier or “ethical wall” to ensure that the investment decision is not made based on information that the equity portfolio manager is not entitled to use.

A hedge fund adviser’s policies and procedures with respect to material nonpublic information must be tailored to that adviser’s specific business and operations.<sup>144</sup> People with access to material nonpublic information who are involved in investment decision making must clearly be on one side of the wall or the other—there can be no “straddling” of the wall. Depending on the size of the organization and the need to share information, effective information barriers may be impractical. SEC examiners will look for both the philosophical and physical integrity of information barriers.<sup>145</sup> Strict controls must be in place to ensure that information does not “leak” through the wall via, for example, electronic systems or through conversations at lunch between analysts.

A related area of current SEC focus concerns the use of so-called “big boy” letters.<sup>146</sup> In a recent enforcement action, the SEC alleged that an adviser traded in bonds while in possession of material nonpublic information it received while sitting on creditors’ committees in the issuers’ bankruptcy cases.<sup>147</sup> In several instances, the adviser gave the counterparties to the trades big boy letters stating that the adviser possessed material nonpublic information that it was not disclos-

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143. SEC, Presentation at the 2007 CCO Outreach Regional Seminars: SEC Examinations and the Risk Assessment Process 12–13 (2007), available at <http://www.sec.gov/info/cco/examprocess2007.pdf>.

144. See *QUESTIONS ADVISERS SHOULD ASK*, *supra* note 135.

145. See *supra* note 135 and accompanying text.

146. “Big boy” letters are used when one party to a transaction possesses nonpublic information that the other party does not. The letter makes clear that the parties understand the disparity in information and still wish to enter into the transaction.

147. SEC v. Barclays Bank PLC, Litigation Release No. 20132, No. 07-CV-04427 (S.D.N.Y. May 30, 2007), available at <http://www.sec.gov/litigation/litreleases/2007/lr20132.htm>.

ing to the counterparties.<sup>148</sup> It is important to note that the use of big boy letters is not a defense in an insider trading case because the letters do not address the breach of duty between the seller and the source of the information. This action is also notable because the SEC found that both senior management and compliance personnel failed to prevent the illegal insider trading, despite receiving notice that the proprietary desk had nonpublic information and should have been restricted from trading.<sup>149</sup> Not surprisingly, OCIE staff has begun including inquiries about the use of big boy letters in the context of adviser examinations.<sup>150</sup>

## 2. *“Information Aggregators”*

Many hedge fund advisers subscribe to the services of outside consultants, or “consultant aggregators,” that provide access to experts in various industries. These experts are not employees of the aggregator but instead are compensated by the aggregator to discuss information with analysts and portfolio managers. Regulators are interested particularly in situations in which the experts actually are employees of public companies in which the buy-side entity has or might invest. They are interested in whether these scenarios present opportunities for company insiders to convey material nonpublic information to buy-side analysts and, accordingly, are interested in the adviser’s related policies and procedures designed to prevent the misuse of such information.

Among the issues to be considered is whether recommendations based on information collected from aggregators are permissible under the “mosaic theory”—a method of analysis whereby an analyst gathers bits of public, nonpublic, and nonmaterial information about a company, which in the aggregate, support the analyst’s thesis about a company.<sup>151</sup> In addition, because aggregators are often compensated via soft dollars,<sup>152</sup> questions arise regarding the appropriate value of their services and the use of commission dollars to pay for those services.

## 3. *Collaboration and Working in “Groups”*

Examiners also have recently shown interest in how portfolio managers share information and ideas with non-affiliated portfolio managers.<sup>153</sup> The concern appears to be that due to the size of the hedge fund industry in general and the magnitude of assets controlled by certain funds in particular, hedge funds are now in a position not only to control companies but to move markets—especially

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148. *Id.*

149. *Id.*

150. *See supra* note 135 and accompanying text.

151. MOSAIC THEORY, INVESTOPEDIA.COM, <http://www.investopedia.com/terms/m/mosaictheory.asp> (last visited Jan. 17, 2008).

152. The term “soft dollars” refers to payments made for research and other related services via trading commissions. *See infra* Part III.C.3.

153. *See supra* note 135 and accompanying text.

if two or more funds comprise a “group” working together to maximize return with respect to a specific issuer or strategy.

In this regard, SEC examiners also look at sharing of client information for confidentiality and material nonpublic information issues.<sup>154</sup> Hedge fund advisers who participate in “idea dinners”—informal gatherings with exclusive invitation lists designed to foster the free exchange of investment ideas—are likely to receive inquiries relating to the adviser’s monitoring of those events.

#### 4. “Value Added” or “Strategic” Investors

Many hedge funds accept investors who potentially bring more to the potential success of the fund than their investment dollars alone. Often these investors are senior officers or directors at public companies or other issuers in which the fund may invest. Recently, SEC examiners have shown interest in these so-called “value added investors,” looking carefully at how these investors “add value” in light of inside information, material nonpublic information, confidentiality, and allocation issues.<sup>155</sup>

### C. Portfolio Management Issues

#### 1. Personal Trading

Rule 204A-1 under the Advisers Act requires that all registered advisers establish, maintain, and enforce a written code of ethics.<sup>156</sup> The rule requires, among other things, quarterly and annual reporting of personal securities holdings and trading.<sup>157</sup> On audit, SEC examiners scrutinize these reports, to both ascertain compliance with the adviser’s policies and procedures and to assess whether any personnel who has access to material nonpublic or trading information has traded in contravention of the best interests of the adviser’s clients.<sup>158</sup> Rule 204-2 under the Advisers Act also requires detailed books and records regarding the code, the persons required to comply with the code, and the history of monitoring and enforcement of the code’s requirements.<sup>159</sup>

A pattern of failure to report timely or accurately, or failure to monitor reporting, can have significant adverse regulatory consequences. For example, in April 2007, the SEC commenced an enforcement action against a mutual fund

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154. *Id.*

155. *Id.*

156. See Investment Advisers Code of Ethics, Investment Company Act Release No. 26492, Investment Advisers Act Release No. 2256, 69 Fed. Reg. 41,696 (Jul. 9, 2004) (rule became effective Aug. 31, 2004).

157. *Id.*

158. See *supra* note 135 and accompanying text.

159. Investment Advisers Code of Ethics, 69 Fed. Reg. 41,696.

portfolio manager, alleging antifraud and reporting violations resulting from thousands of undisclosed personal stock trades.<sup>160</sup>

In a related vein, examiners will pursue arrangements in which an employee trades with a relative, a friend, or another person with whom that employee has other than a strictly business relationship. Moreover, if a portfolio manager trades with someone with whom he or she has a personal relationship, and the CCO has not asked and does not know about the relationship, the examiners will likely deem that arrangement to evidence a weakness in oversight and require that the adviser rebut a presumption that the arrangement is inappropriate.<sup>161</sup>

## 2. Best Execution

All hedge fund advisers have a fiduciary duty to seek best execution when trading on behalf of their clients.<sup>162</sup> “Best execution” is commonly understood to require that the adviser obtain “the most favorable terms reasonably available under the circumstances for customer transactions,”<sup>163</sup> not necessarily that the adviser obtain the lowest price, and the obligation applies to all types of securities trading, including both equity and debt.

Among best execution failures cited by the SEC in recent years, “directed brokerage” and “revenue sharing” arrangements have received particular attention. Advisers who trade with brokers with whom they have quid pro quo arrangements will be subject to intense regulatory scrutiny. For example, in *In re Jamison, Eaton & Wood, Inc.*, the SEC alleged that an adviser traded with brokers who referred clients to the adviser without (a) disclosing the potential conflict of interest to the clients, (b) informing the clients that other full service brokerage options were available at lower cost, and (c) seeking best net results for its clients.<sup>164</sup>

In SEC examinations, examiners focus on all aspects of best execution, including the broker-dealer selection process, the quality and speed of broker responsiveness, and the determination of fair commission or spread in the context of

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160. *In re Geoffrey Brod*, Investment Company Act Release No. 27780, 2007 SEC LEXIS 715 (Apr. 9, 2007), available at <http://www.sec.gov/litigation/admin/2007/ia-2600-o.pdf>. Mr. Brod has declined to settle with the SEC and is instead pursuing a public hearing before an SEC administrative law judge.

161. See *supra* note 135 and accompanying text.

162. See, e.g., Andrew J. Donohue, Dir., Div. of Inv. Mgmt, SEC, Keynote Luncheon Address Before the SIA Institutional Brokerage Conference (Oct. 30, 2006), available at <http://www.sec.gov/news/speech/2006/spch103006ajd.htm>.

163. See, e.g., SEC, OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS: EXAMINATIONS OF BROKER-DEALERS OFFERING ONLINE TRADING: SUMMARY OF FINDINGS AND RECOMMENDATIONS (2001), <http://www.sec.gov/news/studies/online.htm> [hereinafter EXAMINATIONS OF BROKER-DEALERS OFFERING ONLINE TRADING].

164. *In re Jamison, Eaton & Wood*, Investment Advisers Act Release No. 2129, 2003 SEC LEXIS 1174 (May 15, 2003), available at <http://www.sec.gov/litigation/admin/ia-2129.htm>.

each type of security traded, as well as other benefits.<sup>165</sup> One-size-fits-all approaches to policies and procedures are generally frowned upon, as is less-than-rigorous or absent monitoring of those procedures. Examiners seek to determine whether advisers are “periodically and systematically” assessing execution, and the more complex a fund’s investment strategies are, the more detailed the process is expected to be.<sup>166</sup> In 2006, OCIE officials identified weaknesses in controls and failure to adequately manage, identify, and disclose conflicts in brokerage arrangements as two of the top five deficiencies found in SEC adviser examinations.<sup>167</sup>

### 3. *Soft Dollars*

Section 28(e) of the Exchange Act provides a non-exclusive “safe harbor” to advisers for payments made for research and other related services via trading commissions.<sup>168</sup> The Section 28(e) safe harbor, which often results in an adviser paying more than the price of execution in exchange for qualifying research services, has been the subject of controversy virtually since its enactment. Because commissions are client assets, advisers have a fiduciary responsibility to use them responsibly, to disclose fairly how they will be used, and to use them in the ultimate best interest of the clients. In July 2006, the SEC issued an interpretive release that clarified certain issues relating to, among other things, the proper use of soft dollars and the types of services that would qualify for the safe harbor, but the dialog and debate over the use of soft dollars continues.<sup>169</sup>

At the SIFMA March 2007 Law and Compliance Conference, James Shorris, then head of enforcement for NASD, discussed concerns about soft dollar issues such as broker-dealers paying for parking tickets, credit card bills, and home theaters for hedge funds staff.<sup>170</sup> SEC Enforcement Director Thomsen said the SEC was looking at so-called “hedge fund hotels,” or office space given to hedge funds by broker-dealers in return for brokerage business.<sup>171</sup> Examiners are also

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165. *Id.* at \*15; *see also* EXAMINATIONS OF BROKER-DEALERS OFFERING ONLINE TRADING, *supra* note 163, § III.

166. *Jamison, Eaton & Wood*, 2003 SEC, LEXIS 1174, at \*7.

167. *See Highlights from “SEC Speaks” 2006*, *supra* note 3.

168. 15 U.S.C. § 78bb(e) (2000).

169. Commission Guidelines Regarding Client Commission Practices Under Section 28(e) of the Securities and Exchange Act of 1934, Exchange Act Release No. 54165, 71 Fed. Reg. 41978 (July 24, 2006) (to be codified at 17 C.F.R. pt. 241).

170. *See SIFMA 2007 Conference—Remarks from Regulators*, SEC. L. UPDATE (Sidley Austin LLP, New York, N.Y.) (Apr. 9, 2007) [hereinafter *SIFMA 2007 Conference*]. In July 2007, NASD and NYSE Member Regulation consolidated to form FINRA. *See* FINRA, <http://www.finra.org/About-FINRA/CorporateInformation/index.htm> (last visited Jan. 14, 2008).

171. *See SIFMA 2007 Conference*, *supra* note 170.

looking at the adequacy of soft dollar disclosure. In May 2007, Chairman Cox called for the repeal or, at least, substantial revision of, Section 28(e).<sup>172</sup>

While the future regulation of soft dollars is uncertain, it is clear that arrangements whereby advisers are perceived to “pay up” for research or other services will continue to be scrutinized on SEC audit. Best execution principles, as well as questions regarding self-dealing and conflicts of interest, are carefully considered when evaluating soft dollar arrangements. OCIE Associate Director Gene Gohlke has indicated that SEC staff will require at a minimum that the value of the services for which investors pay be reasonably related to what they paid.<sup>173</sup>

#### 4. Valuation

Accurate valuation of portfolio securities is critical for funds, both for purposes of pricing fund shares and for purposes of calculating fees and performance. There is no accepted concept of “conservative” pricing, particularly in the context of funds whose shares or units are offered or redeemed periodically.<sup>174</sup> Hedge funds and other alternative investment vehicles are particularly difficult to price, because they tend to focus on harder-to-value instruments like private placements, securitized structures, distressed securities, and illiquid securities. Maintenance of accurate and defensible pricing becomes even more important when an adviser manages different types of vehicles side-by-side, such as hedge funds, mutual funds, private equity, and/or separate accounts. Volatile markets further complicate valuation issues for hedge funds; many of the instruments in which these funds invest do not have readily available market prices and therefore must be “fair valued” according to principles that are constantly revisited.<sup>175</sup> In any event, valuation procedures must be fully disclosed, well understood, and consistently applied.<sup>176</sup>

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172. Letter from Christopher Cox, SEC Chairman, to Christopher Dodd, U.S. Senator (May 17, 2007) (copy on file with author) (“I am concerned that this overly complicated provision of the law hurts investors and U.S. capital markets by protecting arrangements that involve substantial conflicts of interest, may contribute to higher brokerage costs, is difficult to administer, and may operate to impede the further development of efficient markets for brokerage as well as certain advisory services.”).

173. Richard Hill, *Disclosure: Gohlke Says OCIE Focusing On Disclosure of Soft Dollar Conflicts*, SEC. L. DAILY (BNA), Oct. 20, 2006.

174. See, e.g., Andrew J. Donohue, Dir., Div. of Investment Mgmt., SEC, Opening Remarks Before the CCO Outreach National Seminar (Nov. 14, 2007), available at <http://www.sec.gov/news/speech/2007/spch111407ajd.htm>.

175. For example, in 2006, the Financial Accounting Standards Board issued Statement No. 157, Fair Value Measurements (“FAS 157”). FAIR VALUE MEASUREMENTS, Summary of Statement No. 157 (Fin. Accounting Standards Bd. 2006), available at <http://72.3.243.42/st/summary/stsum157.shtml>. FAS 157 was designed to address the extent to which entities, including hedge funds, measure and provide information to investors regarding “fair value” of portfolio investments. Developments in 2007 surrounding the valuation of certain mortgage-backed securities and related derivative products in which hedge funds invest have further highlighted the application of FAS 157 to hedge funds.

176. See Donohue, *supra* note 174.

### 5. *Allocation*

Equally important, and scrupulously scrutinized, are fund allocation procedures. On audit, SEC examiners seek to confirm that procedures governing allocation of securities are designed to ensure that opportunities are fairly allocated among all clients.<sup>177</sup> There is no single acceptable or appropriate way to allocate—depending on the instrument, advisers may choose to allocate pro rata, on a rotation system, or by another method. Whatever method is chosen, however, a retrospective review should reflect equitable allocation across clients over time. Examiners look for “silos”—individual portfolio managers or management teams within advisers who do not share opportunities.<sup>178</sup> Procedures should seek equitable allocation both within a silo and across silos.

#### D. *Other Areas of SEC Exam Focus*

##### 1. *Books and Records*

Although the SEC staff has indicated that it will no longer seek routine review of email correspondence, the staff retains the right to ask for emails from particular individuals or with respect to particular issues in which the staff might be interested.<sup>179</sup> Moreover, OCIE staff has indicated that advisers who systematically delete emails will be asked to justify the system of deletion—for example, how does the adviser know that the deleted email did not contain a required book or record?<sup>180</sup> Given the difficulty in proving this negative, many advisers elect to retain everything, which results in a costly and cumbersome storage, cataloging, and retrieval problem.

In 2006, OCIE staff indicated that guidance would be forthcoming regarding the staff's position on email retention.<sup>181</sup> More recently, however, Andrew “Buddy” Donohue, director of the SEC's Division of Investment Management, has indicated that email retention, review, and production regulations will be considered in connection with a comprehensive review and rethinking by the SEC staff of the adviser books and records rules.<sup>182</sup> As of the end of 2007, however, no additional SEC guidance was forthcoming.

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177. *See supra* note 135 and accompanying text.

178. *Id.*

179. ACA Compliance Group, *New OCIE Policy: No Initial E-Mail Requests in Routine Exams*, IM INSIGHT, Nov. 21, 2005 (copy on file with author).

180. *See, e.g.*, Lori A. Richards, Dir., Office of Compliance Inspections and Examinations, SEC, Remarks Before the Greater Cincinnati Mutual Fund Association Directors' Workshop (Sept. 22, 2005), *available at* <http://www.sec.gov/news/speech/spch092205lr.htm>.

181. Paul S. Watkins, Commissioner, SEC, Remarks Before the IA Compliance Best Practices Summit 2006 (Feb. 28, 2006), *available at* <http://sec.gov/news/speech/spch022806psa.htm>.

182. Andrew Donohue, Dir., Div. of Investment Management, SEC, Remarks Before the IA Week and the Investment Adviser Association 9th Annual IA Compliance Best Practices Summit 2007 (Mar. 22, 2007), *available at* <http://sec.gov/news/speech/2007/spch032207ajd.htm>.

## 2. *Side Letters*

Examiners are looking at special relationships with investors in general and side letters in particular. Side letters evidence special arrangements with certain clients. Susan Ferris Wyderko, the former acting director of the SEC's Division of Investment Management, highlighted two main SEC concerns with respect to side letters: (a) terms that may benefit one investor at the expense of others, and (b) the adequacy of disclosure to other investors.<sup>183</sup> Certain terms that do not affect a fund's portfolio or raise liquidity concerns are unlikely to harm investors in the fund generally, and, if properly disclosed, are unlikely to be deemed a violation of the adviser's fiduciary duty. These "low risk" terms include "most favored nation" clauses,<sup>184</sup> favorable fee arrangements, or the right to transfer to an affiliate or to determine form of redemption payment. "Higher risk" side letters—terms that raise fiduciary issues that cannot necessarily be cured by disclosure—include preferential liquidity terms, preferential access to portfolio information, advance notice of redemptions, and guaranteed access to fund capacity.<sup>185</sup>

## 3. *Funds of Funds*

Funds of funds raise unique issues for SEC examiners. For example, to what extent is the "top" fund responsible for evaluating the compliance and regulatory policies and procedures of the underlying funds? Should the due diligence process contemplate review of pricing and valuation, performance calculation, or allocation? Is there a specifically articulated due diligence protocol, and how is consistency and compliance with that protocol monitored and enforced?<sup>186</sup> In addition, recent developments that complicate hedge fund valuation generally raise new challenges for funds of funds in particular.<sup>187</sup>

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183. *Role of Hedge Funds in Our Capital Markets: Hearing Before the S. Subcommittee on Securities and Investment*, 109th Cong. (2006) (statement of Susan Ferris Wyderko, Acting Director, Division of Investment Management, SEC), available at <http://www.sec.gov/news/testimony/ts051606sfw.htm>.

184. A "most favored nation" clause provides that the recipient of the most favored nation status will always be treated at least as favorably as any other client.

185. The U.K. Financial Services Authority ("FSA") also is scrutinizing side letters, expressing concern in a recent statement that the undisclosed use of side letters may result in "some, often large, investors receiving more information and preferential (early) redemption terms compared with other investors in the same share class . . . ." FSA, HEDGE FUNDS: A DISCUSSION OF RISK AND REGULATORY ENGAGEMENT, FEEDBACK ON DP05/4 6 (Mar. 2006), available at [http://www.fsa.gov.uk/pubs/discussion/fs06\\_02.pdf](http://www.fsa.gov.uk/pubs/discussion/fs06_02.pdf). The FSA stated that it expects "managers to ensure that all investors are informed when a side letter is granted and any conflicts that may arise are adequately managed." *Id.* (emphasis omitted).

186. For a discussion of how an adviser to a fund of funds might go about establishing a compliance process for valuing the fund's assets, see Remarks before the Fund of Funds, *supra* note 139.

187. See *supra* note 175 and accompanying text. Advisers to funds of funds that invest in underlying funds, which themselves invest in volatile, fair valued securities may find valuation more challenging than historically was the case.

#### 4. *Performance Advertising*

In addition to routine examinations conducted at individual advisers, OCIE also conducts “sweep exams” that target specific issues within a cross-section of advisers.<sup>188</sup> During a recent risk-targeted sweep exam focusing on performance advertising, SEC examiners identified a number of deficiencies.<sup>189</sup> The most common deficiencies involved disclosure issues, including: (a) failure to deduct advisory fees from performance results; (b) failure to disclose whether results reflect reinvested dividends; (c) failure to disclose material facts regarding a particular index used to benchmark performance claims; and (d) inappropriate use of past specific recommendations.<sup>190</sup>

Certain advisers lacked compliance policies and procedures governing marketing and performance advertising, and others maintained procedures that, in the staff’s view, did not appear to be effective. For example, inadequate policies and procedures did not:

[a] address the operations or practices of the adviser’s businesses; [b] ensure that third-party consultants used compliant presentations; [c] address the methods the adviser used to treat cash (and equivalents) when ‘carving out’ separate equity and fixed income performance from balanced accounts; [d] ensure compliance with all applicable requirements of the CFA Institute’s performance presentation standards (currently called “Global Investment Performance Standards” or “GIPS”) prior to making a claim of such compliance; [e] require a consistent comparison of composites to appropriate benchmarks; and [f] ensure accurate composite descriptions.<sup>191</sup>

Some examples of policies and procedures in place at the firms with fewer deficiencies included: [a] a multi-level review process among the adviser’s employee groups that manage assets, calculate performance and market fund shares for the accuracy of marketing materials prior to their use; [b] the creation of “tolerance reports” on a monthly basis to compare all composite accounts to their respective benchmarks, with any material discrepancies subsequently investigated; [c] a composite committee review of all accounts on at least a quarterly basis to ensure proper composite construction and maintenance; and [d] the use of a second independent pricing service to periodically verify the accuracy of prices.<sup>192</sup>

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188. *See supra* note 135 and accompanying text.

189. SEC, COMPLIANCEALERT: JUNE 2007 (2007), <http://www.sec.gov/about/offices/ocie/complialert.htm>. [hereinafter COMPLIANCEALERT].

190. SEC, CCOUTCHEACH 2007 REGIONAL SEMINARS 11–12 (2007), *available at* <http://www.sec.gov/info/cco/information2007.pdf> [hereinafter CCOUTCHEACH].

191. COMPLIANCEALERT, *supra* note 189.

192. *Id.*

### 5. *Safeguarding Information*

“Identity thieves appear to be directing increased attention to the securities business, and their attacks are growing in sophistication,” warned OCIE Associate Director and Chief Counsel John H. Walsh in an October 2006 speech.<sup>193</sup> In response, OCIE has initiated a new sweep exam program, examining broker-dealers’ and advisers’ policies and procedures for preventing identity theft.<sup>194</sup> In general examinations the SEC staff is also focusing heightened attention on a firm’s “information security” or “safeguarding” controls for protecting client information.<sup>195</sup> OCIE Director Lori A. Richards has identified this area as associated with a number of deficiencies found in 2006 exams and a compliance requirement to which advisers should be “particularly attuned.”<sup>196</sup> Issues include protecting both electronic and paper-based information and controls over customers’ personal information, the creation and sending of account statements, and the security of account and position valuations.<sup>197</sup>

The safeguarding portion of Regulation S-P, the SEC’s privacy regulation, requires registered advisers to adopt written policies and procedures that address the protection of customer information and records.

[These] policies and procedures must be reasonably designed to: (a) [i]nsure the security and confidentiality of customer records and information; (b) [p]rotect against any anticipated threats or hazards to the security or integrity of customer records and information; and (c) [p]rotect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer.<sup>198</sup>

SEC staff review of an adviser’s safeguarding program may include, among other things, evaluation of: (a) methods used to identify and assess the risks to client information; (b) effectiveness of safeguards for controlling these risks (e.g., management and staffing, intrusion detection and response, data center physical security, firewalls, laptop security); (c) the firm’s response to information breaches and steps taken to prevent a recurrence; (d) the firm’s monitoring and testing of its safeguarding program; (e) protection of proprietary portfolio management information, including monitoring of personal trading by persons who have access

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193. John H. Walsh, Assoc. Dir., Chief Counsel, Office of Compliance Inspections and Examinations, Compliance Professionals versus Identity Thieves, NRS 21st Annual Fall Compliance Conference (Oct. 5, 2006), available at <http://www.sec.gov/news/speech/2006/spch100506jhw.htm>.

194. *Id.*

195. *Id.*

196. Lori A. Richards, Dir., Office of Compliance Inspections and Examinations, SEC, The Process of Compliance, speech before the National Membership Meeting of the National Society of Compliance Professionals (Oct. 19, 2006), available at <http://www.sec.gov/news/speech/2006/spch101906lar.htm>.

197. *Id.*

198. 17 C.F.R. § 248.30 (2007).

to material non-public information; and (f) whether policies and procedures are designed to adequately address changes in the firm's business or operations and ongoing technological developments.<sup>199</sup>

#### 6. *Accuracy and Adequacy of Disclosure*

Among the most frequently identified deficiencies in SEC examinations are inaccurate or incomplete disclosures.<sup>200</sup> As part of its fiduciary duty, an adviser has an obligation of full and fair disclosure of all material facts to clients. During inspections, SEC examiners review an adviser's filings with the SEC and materials provided to clients (including Form ADV Parts 1 and II, offering documents, and advertisements) to ensure that the adviser's disclosures are accurate, timely, consistent, and do not omit material information.<sup>201</sup> As OCIE Director Richards noted, "[a]ny discrepancies between the written disclosure and actual practice, or any inaccurate, incomplete, or untimely materials, indicate weak internal control processes and will heighten scrutiny by examination staff."<sup>202</sup>

Common examples of inaccurate or incomplete disclosures noted in recent examinations include: (a) failure to disclose all material conflicts of interest that surround and influence a firm's business, including, for example, with respect to investment decision-making and brokerage arrangements; (b) failure to adequately disclose all industry activities and affiliations; and (c) use of soft dollars that conflicts with disclosures to clients.<sup>203</sup>

The Commission voted unanimously in July 2007 to adopt a new "anti-fraud rule" under the Advisers Act.<sup>204</sup> New Rule 206(4)-8 makes it a fraudulent, deceptive, or manipulative act for an investment adviser to a pooled investment vehicle (including a hedge fund) to make false or misleading statements (including via omission of a material fact) to investors, prospective investors, or prospective investors in that pool.<sup>205</sup> In the proposing release, the SEC staff noted that the rule will "prohibit, for example, materially false and misleading statements regarding investment strategies [funds] will pursue (including strategies the adviser may pursue for the [fund] in the future), the experience and credentials of the adviser (or its associated persons), the risks associated with in-

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199. *See supra* note 135 and accompanying text.

200. *Id.*

201. *Id.*

202. Lori A. Richards, Dir., Office of Compliance Inspections and Examinations, SEC, Compliance Issues for Investment Advisers Today, Remarks at Investment Counsel Association/IA Week Investment Adviser Compliance Summit (Apr. 28, 2003), *available at* <http://www.sec.gov/news/speech/spch042803lar.htm>.

203. CCOUTREACH, *supra* note 190.

204. Press Release, SEC, SEC Votes to Adopt Antifraud Rule Under Investment Advisers Act (July 11, 2007), *available at* <http://www.sec.gov/news/press/2007/2007-133.htm>.

205. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Investment Advisers Act Release No. 2628, 2007 SEC LEXIS 1736 (Aug. 3, 2007) (to be codified at 17 C.F.R. pt. 275).

vestment in [funds],” the performance of the fund or other funds advised by the adviser, the valuation of the fund and “practices the adviser follows in the operation of its advisory business, such as how the adviser allocates investment opportunities.”<sup>206</sup>

### 7. *Contingency Planning*

Among the components of a comprehensive adviser compliance program often overlooked, the SEC staff has noted the absence of effective “contingency” or “disaster recovery” procedures.<sup>207</sup> In a 2007 letter, the staff noted “lessons learned” collected from advisers that had been affected by Hurricane Katrina.<sup>208</sup> Certain provisions in disaster recovery plans, said the staff, “appeared to be effective with respect to the adviser’s ability to provide uninterrupted advisory services to clients in a compliant manner after a disaster.”<sup>209</sup> Particular provisions noted as effective included:

[a] a pre-arranged remote location . . . ; [b] alternate communication protocols to contact staff and clients, such as cell phones, text messaging, web-based email accounts, or an internet website; [c] [appropriately secure] remote access to business records and client data . . . ; [d] temporary lodging for key staff . . . ; [e] maintaining accurate and up-to-date contact information for all third-party service providers . . . ; [f] familiarity with the business continuity plans of such third-party service providers; [g] contingency arrangements for loss of key personnel . . . ; [h] effective training of staff on how to fulfill essential duties in the event of a disaster . . . ; and [i] maintaining sufficient insurance and financial liquidity to prevent any interruption to the performance of compliant advisory services.<sup>210</sup>

## IV. SEC ENFORCEMENT PROCESS

About two and a half years have passed since Christopher Cox took over as chairman of the SEC. When he became chairman, Cox pledged that enforcement would be his top priority.<sup>211</sup> At least three process-type trends have since emerged concerning enforcement under Cox. First, the Commission appears to be

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206. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Securities Act Release No. 8766, Investment Advisers Act Release No. 2576, 2006 SEC LEXIS 3157, at \*21 (Dec. 27, 2006).

207. COMPLIANCEALERT, *supra* note 189.

208. *Id.*

209. *Id.*

210. *Id.*

211. *Hearing on Pending Nominations Before the S. Comm. on Banking, Housing and Urban Affairs*, 109th Cong. 12–14 (2005) (statement of Rep. Christopher Cox, presidential nominee for chairman of the SEC).

showing greater oversight concerning the enforcement process; second, the SEC appears to be bringing more cases based on old conduct; and, third, there appears to be some disunity among the commissioners concerning certain important enforcement-related issues.

### A. Commission Oversight

In a number of ways, the Commission appears to be demonstrating greater oversight on the enforcement staff. For example, in April 2007, SEC Chairman Cox announced an important change to settlement procedures for SEC enforcement actions.<sup>212</sup> The change, applicable to select cases against public companies, requires the SEC staff to obtain Commission approval before engaging in settlement negotiations with prospective defendants or respondents. The new policy differs from the previous status quo, in which the SEC staff freely negotiated settlements with prospective defendants and respondents without Commission authority, reached an agreement in principle, and then presented the settlement to the Commission for approval.

In 2006, the SEC announced a policy imposing greater commissioner supervision over SEC staff when it seeks to issue subpoenas to the media.<sup>213</sup> Under that new policy, the staff needs to obtain the approval of the SEC's enforcement director, and notify the chairman's office, before issuing subpoenas to the press.<sup>214</sup> Although the policy does not itself have a great impact on how the staff conducts investigations, since the staff rarely issues subpoenas to the press, it evidences a skepticism among some commissioners with the staff's ability to exercise independent judgment.

### B. Age of Conduct

More SEC cases seem to be involving old conduct. A March 2007 case, *In re Banc of America Securities LLC*, involved research analyst issues from 1999 to 2001.<sup>215</sup> Another case filed in May 2007, *In re Motorola, Inc.*, involved allegations that during 2000 to 2001 Motorola engaged in transactions that enabled Adelphia Communications Corporation to commit accounting fraud.<sup>216</sup> These and other cases that involve conduct more than five years old suggest a departure from the theme of "real time enforcement" that characterized

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212. Christopher Cox, Chairman, SEC, Address to the Mutual Fund Directors Forum Seventh Annual Policy Conference (Apr. 13, 2007), available at <http://www.sec.gov/news/speech/2007/spch041207cc.htm>.

213. Press Release, SEC, Policy Statement of the SEC Concerning Subpoenas to Members of the News Media (Apr. 12, 2006), available at <http://www.sec.gov/news/press/2006/2006-55.htm>.

214. *Id.*

215. *In re Banc of America Sec. LLC*, Exchange Act Release No. 55466, 2007 SEC LEXIS 492 (Mar. 14, 2007), available at <http://www.sec.gov/litigation/admin/2007/34-55466.pdf>.

216. *In re Motorola, Inc.*, Exchange Act Release No. 55725, 2007 SEC LEXIS 955 (May 8, 2007), available at <http://www.sec.gov/litigation/admin/2007/34-55725.pdf>.

the Commission's enforcement efforts during Harvey Pitt's tenure as chairman earlier in the decade.

*C. Less Unity Among Commissioners than Meets the Eye?*

The three Republicans and two Democrats that until recently comprised the Commission split down ideological lines concerning a number of issues. Enforcement process issues are no different. In January 2006, for example, the SEC issued a statement explaining the criteria it would apply when assessing the need for civil monetary penalties against public companies.<sup>217</sup> In the Penalties Statement and Chairman Cox's accompanying remarks, the Commission emphasized that it was acting unanimously. Chairman Cox, for example, stated how "[a]fter much deliberation the Commission has reached *unanimous agreement* on guidelines that will inform our future actions."<sup>218</sup> He later stated that "[i]t is a source of particular satisfaction to me that, through careful deliberation, our various views were forged into a single general framework."<sup>219</sup> The Penalties Statement, however, never actually applied its penalties criteria to the facts of the two particular enforcement matters that served as its catalyst, *SEC v. McAfee, Inc.*<sup>220</sup> and *In re Applix, Inc.*<sup>221</sup> Instead, the Commission left that important analysis to the SEC Enforcement Director Thomsen, who provided some explanation in separate remarks and in the separate press release for *McAfee*.<sup>222</sup>

By contrast, the SEC's 2001 Section 21(a) Report not only laid out general factors that the Commission said it would consider when deciding whether and how to take enforcement action against companies, but explained, under the particular facts at hand, exactly why it was not taking enforcement action in the specific case before it.<sup>223</sup> Quite possibly, the commissioners were less united in their reasons for imposing a \$50 million penalty in *McAfee* and accepting no penalty in *Applix* than they were in their support for the general framework.

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217. Press Release, SEC, Statement of the SEC Concerning Financial Penalties (Jan. 4, 2006), *available at* <http://www.sec.gov/news/press/2006-4.htm>.

218. Christopher Cox, Chairman, SEC, Statement of Chairman Cox Concerning Objective Standards for Corporate Penalties (Jan. 4, 2006), *available at* <http://www.sec.gov/news/speech/spch010406cc.htm> (emphasis added).

219. *Id.*

220. *SEC v McAfee, Inc.*, SEC Litigation Release No. 19520, 2006 SEC LEXIS 2 (Jan. 4, 2006), *available at* <http://www.sec.gov/litigation/litreleases/lr19520.htm>.

221. *In re Applix, Inc.*, Securities Act Release No. 8651, Exchange Act Release No. 53049, 2006 SEC LEXIS 8 (Jan. 4, 2006), *available at* <http://www.sec.gov/litigation/admin/33-8651.pdf>.

222. Linda Chatman Thomsen, Dir., Div. of Enforcement, SEC, Statement regarding McAfee, Inc. and Applix, Inc. (Jan. 4, 2006), *available at* <http://www.sec.gov/news/speech/spch010406lct.htm>.

223. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44969, 2001 SEC LEXIS 2210 (Oct. 23, 2001), *available at* <http://www.sec.gov/litigation/investreport/34-44969.htm>.

For over a year after the Penalties Statement, the Commission reportedly was deadlocked on how to apply civil penalties against public companies in options backdating cases.

Similarly, the commissioners have shown disunity concerning the settlement process for public companies announced in April 2007 and discussed above. Shortly after Chairman Cox announced the new policy for requiring Commission approval before the staff could negotiate settlements against public companies, Commissioner Roel Campos publicly objected to it on grounds that it improperly constrained the staff.<sup>224</sup>

What do these apparent changes mean for hedge funds? First, greater Commission supervision of the staff can mean longer investigations, even if the ultimate result is for the SEC to close an investigation after developing a record that misconduct did *not* occur. Second, the trend toward “older” cases means that SEC investigations are now more likely to focus on transactions and activities that took place years ago. Significantly, although certain statutes of limitation govern particular types of remedies available to the SEC, there is no general statute of limitation on SEC enforcement actions *per se*. Nor is the equitable doctrine of “laches” often available as an affirmative defense in SEC enforcement actions. Finally, the apparent disunity among commissioners could help prospective defendants, such as hedge funds, in matters involving novel factual or legal questions and conduct that is arguably defensible. In garden variety cases presenting straightforward legal questions, however, the Commission is far more likely to unify and accept recommendations by the SEC staff.

## V. CONCLUSION

Hedge funds likely will remain an important focus for the SEC during the remainder of Chairman Cox’s tenure as chairman, and, quite possibly, well after that. What is more, regulatory interest is not likely to remain confined to the SEC. State regulators have indicated an interest in hedge funds. The New York attorney general has been investigating issues associated with “consultant aggregators,” mentioned above. The Massachusetts Securities Division, under the authority of Secretary William Galvin, also has shown increasing interest in hedge funds. In January 2007, Galvin filed an administrative complaint against activist hedge fund manager Phillip Goldstein for allegedly making an unregistered securities offering of his fund in violation of the Massachusetts Uniform Securities Act.<sup>225</sup> In June 2007, Galvin filed an administrative complaint alleging that a hedge fund prime broker engaged in “dishonest and unethical practices” in

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224. Jesse Westbrook, *Campos Says SEC Fine Policy Raises ‘Grave Concerns,’* BLOOMBERG, Apr. 25, 2007.

225. Administrative Complaint, *In re* Bulldog Investors General Partnership, et al., No. E-07-0002 (Jan. 31, 2007), available at <http://www.sec.state.ma.us/sct/sctbulldog/bulldogidx.htm>.

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providing certain benefits, such as office space, to hedge fund advisers.<sup>226</sup> Hedge funds are well advised to take note of the many issues raised by the regulatory enforcement actions and examiners, and to routinely examine their written policies and procedures in order to make sure those policies and procedures reflect the current landscape.

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226. Administrative Complaint, *In re* UBS Securities, LLC, No. E-2007-0049 (June 27, 2007), *available at* [http://www.sec.state.ma.us/sct/sctubs/ubs\\_complaint.pdf](http://www.sec.state.ma.us/sct/sctubs/ubs_complaint.pdf). For further information on NASD and NYSE rules and proposals relating to gifts and entertainment, see *Gift and Entertainment Developments*, MARKET REGULATION UPDATE (Sidley Austin LLP, N.Y., New York) (Dec. 2006), *available at* <http://www.sidley.com/db30/cgi-bin/pubs/MarketRegDec06.pdf>; *NYSE and NASD Proposes Address Business Entertainment*, MARKET REGULATION UPDATE (Sidley Austin LLP, New York, N.Y.) (Feb. 23, 2006), *available at* <http://www.sidley.com/db30/cgi-bin/pubs/MarketRegFeb2306.pdf>.