The HEDGE FUND LAW REPORT

The definitive source of actionable intelligence on hedge fund law and regulation

www.hflawreport.com | Volume 10, Number 1 | January 5, 2017

SEC ENFORCEMENT

BakerHostetler Panel Analyzes Shifts in Enforcement Policies and Tactics As Industry Anticipates New Administration and SEC Chair (Part One of Two)

By Michael Washburn

The hedge fund industry stands at an uncertain juncture, with a new president set to take office in Washington in January 2017, and the announcement that SEC Chair Mary Jo White will be stepping down in the same month. While some observers expect the administration of incoming President Donald J. Trump to be generally pro-business and averse to overregulation, it may not be easy to alter or transform an environment in which aggressive financial regulatory policies have become the norm – including a rigorous crackdown on "pay to play" practices, insider trading and conflicts of interest; a growing use of, and reliance on, innovative data analytics to prosecute traders and investment managers; aggressive whistleblower incentives; and a push to bring enforcement cases on the SEC's "home turf" through administrative law proceedings.

The above practices have had and continue to have an immeasurable impact on the hedge fund sector and were the subject of a recent panel discussion, entitled "The Ins and Outs of the SEC Enforcement Program and Its Arsenal Against Hedge Funds," hosted by BakerHostetler. The panelists were Marc Powers, national leader of BakerHostetler's hedge fund industry and securities litigation practices; Mark Kornfeld, a partner in the firm's securities litigation practice; Walter Van Dorn, partner and national leader of the firm's international securities and capital markets practices; and Michelle Chopper, director of the advisory and consulting practices at Arthur Bell.

The key takeaways from the panel are presented in this two-part series. This first article reviews the nuances and potential pitfalls of the pay to play rule, the current priorities of the SEC's enforcement program and the role of technology in detecting violations. The second article will discuss the SEC's use of administrative proceedings to try enforcement cases, the impact of the Dodd-Frank Act's whistleblower program and guidance for managers on approaching a regulatory exam or investigation.

For recent insight from Powers and Kornfeld, see "'*Gatekeeper' Actions by the SEC and Investors Against Administrators Challenge Private Fund Industry*" (Sep. 8, 2016); and "*A New Look at an Old Standard: The Power of Minority Bondholders Under the Trust Indenture Act*" (Mar. 5, 2015).

The Regulatory Climate at Mary Jo White's SEC

As Kornfeld characterized it, the climate at the SEC under Chair White has been extremely aggressive about enforcing laws in the aftermath of the 2008 financial crisis and the debacles of Lehman Brothers, Bear Stearns and the Madoff scandal. Kornfeld said that he and his colleagues describe the enforcement climate as the new normal, and emphasized the far-reaching ramifications of this reality for the investment advisory, investment company and hedge fund sectors.

The Pay to Play Crackdown

Defining Pay to Play

Not everyone may agree on what exactly constitutes pay to play, but Van Dorn concisely defined it in the context of the funds market as an investment adviser making a contribution to an elected official in return for favorable decisions in the handling of contracts, the managing of pension plans or the allocation of investments on behalf of a government fund or investment adviser. As one of numerous possible objections to this practice, Van Dorn mentioned the SEC's firm conviction that such donations will inappropriately influence investment decisions by the official, resulting in decisions based on the donations rather than the objective merit of the investment adviser. See "*SEC Starts Year With Pay to Play Penalties*" (Jan. 28, 2016).

Providing a statutory basis for his definition, Van Dorn cited Rule 206(4)-5 under the Investment Advisers Act of 1940 (Advisers Act), commonly referred to as the pay to play rule, which, he said, covers any investment adviser that is registered with the SEC as well as advisers relying on certain exemptions from registration. In his analysis, the essence of the rule is that the adviser cannot receive payment from a government entity for providing investment advisory services – either directly or through any fund vehicle – for two years after making direct or indirect contributions to an official of the government entity.

Pursuant to the record-keeping rule under the Advisers Act, Van Dorn said, an adviser must keep detailed records of all its government advisory clients and political contributions, assuming that it has government advisory clients or advises funds in which government entities invest.

"Not only is this rule on everybody's radar, having recently completed an election, but it's the kind of thing that the SEC is likely to look at in its inspections," Van Dorn cautioned. He added that November 2016's election was the first presidential election since the rule's implementation. Hence, Van Dorn predicted, the SEC may well make the rule a greater area of focus than it has in recent years.

From an investment adviser's point of view, the two-year look-back period provided for by the rule is critically important, emphasized Van Dorn. He noted the broad scope of the rule, which applies to the adviser and "covered associates" of the adviser. Covered associates are defined to include the top rank of management for the adviser, such as the general partner, managing member and executive officers as well as non-executive employees who are involved in the solicitation of business from government entities, as well as their supervisors.

What Contributions Are and How to Make Them

"You'll probably not be surprised to hear that the SEC takes a very broad view of what a contribution is," Van Dorn said. The most obvious example, he continued, is cutting a check. A less obvious but equally applicable definition includes transitional or inaugural expenses provided by a firm to a politician or a political party in the context of a recent election. Van Dorn also noted a subsection of the rule barring advisers from paying third parties, such as broker dealers, to solicit government entities unless the third party itself is covered by substantially equivalent pay to play rules.

There is also a blanket provision that prohibits the adviser and covered associates from doing anything indirectly that, if done directly, would violate the rule. Van Dorn explained that there are two practices in particular that would fall within this prohibition. The first is the concept of bundling, which refers to the practice of getting several people to make smaller donations that in the aggregate would violate the rule. The second involves a government entity that invests in an adviser's pooled vehicle. In this case, while the investment adviser is not providing advice directly to the government entity, the rule still prohibits the receipt of compensation for two years if any contributions are made to an official of the government entity.

There are, however, some exceptions to the prohibition against contributions, Van Dorn noted. He cited the availability of a de minimis exemption for contributions by a covered associate to an official that in the aggregate do not exceed $350 and for which the covered associate was entitled to vote for at the time of the contribution. There is also $150 de minimis exemption for contributions by covered associates where the employee is not entitled to vote for the official.

Another carve-out exists for certain returned contributions. If an adviser discovers a prohibited contribution within four months of its having been made, the contribution is not more than $350 and is returned within 60 days of the adviser having discovered the contribution, the adviser will not be prohibited under the rule from collecting compensation for providing advisory services to the government entity.

"You may be wondering, 'How am I supposed to get this money back?' But imagine any politician who would not give it back if you say you've made an illegal donation. That would be pretty questionable. So it probably should work," Van Dorn advised.

Further stipulations to the $350 exception apply. In the case of an adviser with more than 50 employees, it is possible to use the exception three times a year. If the number of employees is under 50, the exception is available twice a year. Also, this exemption is only available once per an employee.

See "*The SEC's Pay to Play Rule Is Here to Stay: Tips for Hedge Fund Managers to Avoid Liability*" (Oct. 8, 2015); "*Four Pay to Play Traps for Hedge Fund Managers, and How to Avoid Them*" (Feb. 5, 2015); and "*SEC Sanctions Fund Adviser for Violation of 'Pay to Play' Rule and for Failing to Register*" (Jul. 11, 2014).

Insider Trading and Conflicts of Interest

Alluding to figures posted recently on the SEC's website, Kornfeld said that when it comes to the types of activities targeted by enforcement actions, insider trading tops the list.

"There are big names on the board, as always. Leon Cooperman and Omega are embroiled in a pretty significant insider trading matter with the SEC," Kornfeld stated. "A few years ago it was Steven Cohen and SAC Capital, and now it's Leon Cooperman." See "*Alleging Dozens of Violations, SEC Charges Leon Cooperman and Omega Advisors With Insider Trading and Failing to Make Regulatory Filings*" (Sep. 29, 2016); "*SEC Continues to Focus on Insider Trading and Fund Valuation*" (Jun. 30, 2016); and "*SEC Charges Steven A. Cohen with Failing to Supervise Employees Who Allegedly Engaged in Insider Trading*" (Jul. 25, 2013).

Besides insider trading, Kornfeld described 2016 as a year characterized by a heavy volume of Foreign Corrupt Practices Act (FCPA) cases, as exemplified by the $412 million settlement with Och-Ziff announced in September. FCPA enforcement has generally become an increasingly paramount concern for the regulators, Kornfeld argued. See "*Recent SEC and DOJ Settlements With Och-Ziff and Two Executives Underscore FCPA Compliance Risks to Private Fund Managers*" (Oct. 27, 2016).

Another area involves cases of conflicts of interest, among which Kornfeld singled out the prosecution of JPMorgan Wealth. In other significant actions, regulators held Merrill Lynch accountable for the misuse of customer cash, and lodged misconduct charges against investment advisers and investment companies of BlackStone and Fenway Partners. See "*Merrill Lynch Settlement Reminds Hedge Fund Managers to Be Aware of How Brokers Are Handling Their Assets*" (Jul. 7, 2016); "*Full Disclosure of Portfolio Company Fee and Payment Arrangements May Reduce Risk of Conflicts and Enforcement Action*" (Nov. 12, 2015); and "*Blackstone Settles SEC Charges Over Undisclosed Fee Practices*" (Oct. 22, 2015).

Kornfeld described 2016 as a year marked by the highest number of cases – a total of 160 – ever brought in a single year by the SEC against investment advisers and investment companies. This year has also seen the most-ever independent standalone actions, approaching nearly 100, Kornfeld said. In yet another measure of the regulators' emboldened stance, SEC disgorgements and penalties for the last three years have been around $4 billion. See "*What the SEC's Enforcement Statistics Reveal About the Regulator's Focus on Hedge Funds and Investment Advisers*" (Oct. 20, 2016).

"What you get a sense of is that the climate has been very enforcement-centric," Kornfeld clarified, "and that creates a lot of risk for compliance officers, for chief legal officers, for executives, for boards of directors, for investment advisers and for the hedge funds that they service."

The HEDGE FUND LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation

www.hflawreport.com Volume 10, Number 1 January 5, 2017

The Growing Role of Data Analytics

Regulators have pursued their increasingly hawkish policies by using various tools. One utilized increasingly over the past five to six years, Kornfeld said, has been data analytics, which he pointed out has been identified by Andrew Ceresney, former director of the agency's enforcement division, as the new frontier for discovering irregular trading.

The SEC has adopted a new approach to analyzing data, Kornfeld continued, mining billions of rows of data every day to root out trading irregularities on the part of traders and hedge funds. See "*OCIE Director Marc Wyatt Details Use of Technology and Coordination With Other Agencies to Execute OCIE's Four-Pillar Mission*" (Nov. 3, 2016). He suggested that Chair White's choice of words when describing the SEC's methodology here – "expanding the playbook," as she put it – is indicative of a desire to find new ways to bring enforcement actions. He said that it will be interesting to see whether this approach continues, given the pending leadership changes in the U.S.

Providing a statistical basis for his observations, Kornfeld noted that 7 to 8 percent of all insider trading cases since 2014 have come about independently through data mining by the SEC. While acknowledging that the figures are still relatively small on a percentage basis, Kornfeld observed that these actions have generated half a billion dollars in disgorgements. Moreover, the agency is busily hiring statisticians and data analytics experts to study, monitor and analyze trading information.

In this environment, Kornfeld advised investment advisers and investment companies to strive to adopt a parallel approach to data analytics to eliminate even the possibility of irregular trading, style drift or volume trading beyond its proper scope, and he predicted that this area of enforcement will forge ahead into the new presidential administration.

The HEDGE FUND LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation

www.hflawreport.com Volume 10, Number 3 January 19, 2017

SEC ENFORCEMENT

BakerHostetler Panel Analyzes SEC Use of Administrative Proceedings and Whistleblower Incentives, and Provides Guidance for Fund Managers Facing an Examination (Part Two of Two)

By Michael Washburn

As part of the transition to the incoming administration of President-Elect Donald J. Trump, many in the hedge fund industry anticipate the potential for a lighter-touch regulatory approach at the SEC. This was the focus of a recent panel discussion hosted by BakerHostetler, entitled "The Ins and Outs of the SEC Enforcement Program and Its Arsenal Against Hedge Funds." The panelists were Marc Powers, national leader of BakerHostetler's hedge fund industry and securities litigation practices; Mark Kornfeld, a partner in the firm's securities litigation practice; Walter Van Dorn, national leader of the firm's international securities and capital markets practices; and Michelle Chopper, director of the advisory and consulting practices at Arthur Bell.

The key takeaways from the panel are presented in this two-part series. This second article discusses the SEC's practice of trying contested cases through administrative proceedings where administrative law judges (ALJs) hired by the SEC decide the outcome of those cases, evaluates the impact of the Dodd-Frank Act's whistleblower program on SEC enforcement efforts and provides guidance for managers on navigating a regulatory exam or investigation. The first article addressed the SEC's renewed interest in compliance with the pay to play rule, the relentless crack down on insider trading and ways technology is giving the SEC an edge in detecting violations.

For additional insight from Powers, see "*Investment Strategies, Considerations and Uncertainties of Distressed Debt Investments by Hedge Funds*" (Apr. 9, 2015); "*Chapter 15 of the Bankruptcy Code Presents Litigation Risks and Liability for Creditors, Counterparties, Service Providers and Others Doing Business With Bankrupt Offshore Hedge Funds*" (Oct. 3, 2013); and "*Five Takeaways for Other Hedge Fund Managers From the SEC's Record $602 Million Insider Trading Settlement With CR Intrinsic*" (Mar. 21, 2013).

Administrative Law Judge Proceedings

The SEC's decision to bring contested cases in front of ALJs is a controversial issue that raises many legal and even constitutional issues, noted Kornfeld, and it is likely to receive ample attention in the new administration. This penchant for bringing enforcement actions before ALJs is a byproduct of the passage of the Dodd-Frank Act in 2010 – particularly its provision 929P.

"The reason this is important is because administrative law proceedings, unlike proceedings in federal district court, give the defendant less protection," Kornfeld said. He cited three primary characteristics of administrative law proceedings that make this so:

1. There is no discovery of the kind that is common in a more typical litigation.
2. There is no jury trial.
3. Hearsay evidence may come into play in some instances.

The Industry Responds

The lopsided nature of administrative law proceedings has fueled a pushback on the part of lawyers, lobbyists and members of the hedge fund community, Kornfeld said. These individuals object to the appearance of bias in administrative law proceedings funded by SEC budgets and driven by SEC judges.

The
HEDGE FUND
LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation

www.hflawreport.com Volume 10, Number 1 January 19, 2017

There is widespread concern by members of the financial services industry over the appearance of "inside baseball," and a feeling that the SEC deliberately chooses administrative law proceedings because of the agency's overwhelming success at winning matters pursued in this venue, noted Kornfeld. Roughly 90 percent of cases brought in ALJ proceedings have proven successful for the SEC, as opposed to a success rate of 66 percent to 68 percent in cases brought before a federal judge.

The pushback has taken the form of legal challenges. Some challengers have noted that ALJs are not appointed in the same manner as Article 2 judges under the Constitution, while others have argued that these proceedings do not offer the defendant a right to a jury trial and therefore violate the Seventh Amendment. Nevertheless, courts have held that the SEC has the right and authority to assign matters to ALJs in order to adjudicate perceived violations of the securities laws.[1] See "*D.C. Circuit Delivers Significant Victory for the SEC in Upholding the Use of Administrative Law Judges in Enforcement Proceedings*" (Sep. 8, 2016).

"This is important to the industry because it creates a vehicle for the SEC to make it easier to bring an enforcement action, which then requires everyone to have a heightened awareness from a compliance perspective," Kornfeld stated.

Expanding on his point, Kornfeld described proceedings before an ALJ as offering a sort of home-court advantage to the regulators, while putting pressure on the respondents. The proceedings tend to be quicker, and the defendant has limited recourse to an appeal. If the defendant does file an appeal, it will be to the SEC, at least initially, and the SEC is likely to defer to the ALJ. The Chevron defense doctrine is favorable to the winning party, explained Kornfeld. An appeal of the case on Constitutional grounds is likely to drag on for years, and it is far more likely for the case to settle than for it ever to achieve resolution favorable to the respondent based on Seventh-Amendment grounds.

"What happens more often than not is the case settles, which somewhat insulates the matter from any sort of Constitutional scrutiny," Kornfeld explained.

Concessions From the Regulators

The pushback by the funds industry, lawyers and lobbyists against administrative law proceedings has not been entirely fruitless. Kornfeld noted that the regulators have amended their protocol to allow some depositions in administrative law proceedings, in contrast to past practice where the only information respondents could gain access to were SEC transcripts of interviews that the regulators had conducted. Moreover, the timeframe for administrative proceedings is now slightly longer.

Considering the pending transitions to a new presidency and a new SEC Chair, the current question before the industry is whether proposed legislation to shift some or all of the burden of proof to the SEC might gain momentum. For example, Kornfeld suggested that the SEC's current $200 million enforcement action against Lynn Tilton is emblematic of the type of matter where an increased burden of proof on the regulators might have a significant practical impact on the outcome of the action. In this matter, the respondent has accused the SEC of misconduct, of hiring expert witnesses before the actual filing of the complaint and of committing Brady misconduct by not making key evidence available.

Whistleblower Incentives

The growing awareness of whistleblower awards made possible by the Dodd-Frank Act has contributed to more than $100 million in payouts to whistleblowers from the time of the program's launch through the current year, noted Kornfeld. In 2016 alone, there were more than $75 million in new awards. On the Monday before the BakerHostetler conference, an award came through for $28 million.

"This has been a much-publicized part of the enforcement process under this SEC Chair, and the SEC has been focusing on whistleblowing as an extra arrow in the quiver for enforcement purposes," Kornfeld said, describing the program as an added method for the regulators to police the industry. See "*RCA Session Offers Insights on Dodd-Frank Whistleblower Regime, Incentives, Anti-Retaliation Protections and Risks*" (Apr. 9, 2015).

The HEDGE FUND LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation

www.hflawreport.com Volume 10, Number 3 January 19, 2017

Once again, Kornfeld qualified his assessment with an expression of optimism about the potential for change in the coming administration. "I do think there will be some softening of this, and I would venture to guess it will not be in year one, but perhaps in year two," he commented.

Nevertheless, to protect their firms, employers need to carefully manage the departure of employees. It is imperative to protect against the revealing of trade secrets and patented information, as well as to avoid any disparagement of one or another party in such a sensitive situation. See "*How Hedge Fund Managers Can Balance Protecting Confidential Information Against Complying With Whistleblower Laws*" (Aug. 25, 2016).

What employers cannot do, Kornfeld stressed, is imply that employees might be deprived of legal protections they might otherwise enjoy. In the current environment, people with the status of whistleblowers generally enjoy a reputation for performing an important public service, and the regulators will make a point of protecting those who come forward to report misconduct or malfeasance.

"The industry as a whole – chief legal officers, chief compliance officers and those who report to senior management – need to be much more anticipatory in creating a different culture, and a different transparency," Kornfeld said. He emphasized the need for written policies and procedures, tip lines and alerts as means to foster a confidential safe haven for employees who wish to internally report any malfeasance as opposed to blowing the whistle to the SEC. Companies should want to foster such a climate, Kornfeld explained, because the alternative entails risk, liability and potentially devastating damage to the company's reputation. See "How Promoting Internal Reporting Can Reduce Risk of Regulatory Intervention for Hedge Fund Managers" (Aug. 11, 2016); and "Sanctions Against Private Fund Manager for Retaliating Against Whistleblower Highlight the Importance of Incentivizing Internal Reporting" (Jul. 18, 2014).

"Speak to outside counsel, work with chief legal officers and work with consultants and auditors to get the right systems in place to protect yourselves from reputational hits and compliance-type liability," Kornfeld urged.

Responding Properly to SEC Inquiries

Need to Provide Requested Information

Many funds assume a complacent attitude when faced with an investigation or questions that might lead to one, emphasized Kornfeld. Fund personnel too often assume that having a compliance officer and in-house counsel positions them favorably to handle the matter without recourse to an outside service provider.

In such a scenario, however, the fund personnel may not be able to obtain all the information they need to respond properly, a problem compounded by the fact that they are acting under considerable duress, Kornfeld explained. Failure to provide all requested information may lead the regulators to suspect a larger failure at the compliance level.

"How you respond to requests, even in a routine exam, is often what will dictate a routine procedure spiraling into a massive investigation that could have been avoided" by using outside counsel, or possibly a general counsel with proper oversight of the matter, Kornfeld cautioned. Funds that attempt to self-cooperate, as Kornfeld put it, are acting in a penny-wise, pound-foolish manner and unnecessarily increasing risks. See "*Practical Guidance From Former SEC Examiners on Preparing for and Surviving SEC Examinations*" (Sep. 1, 2016); and "*Usable Lessons and Proven Survival Techniques From the Hedge Fund Examination Trenches*" (Oct. 10, 2014).

It is imperative to not underestimate the variety of information that regulators may request, even at the initial stages, warned Chopper. Regarding the examinations that she has worked on recently with her clients, the number of requested items has ranged from 7 to 150.

Managers typically have about two weeks to respond to the SEC's initial information and document request, explained Chopper, and further complications may arise when the client does not have all the data at hand. In these cases, her clients typically need to coordinate with administrators or prime brokers to obtain the necessary information and then put the data into the requested format.

For all the optimism that some have expressed about the incoming administration, Chopper was rather guarded. While the regulators typically announce priorities for a given year in January of that year, she noted that the SEC gave some hints about forthcoming priorities in the week before the panel discussion. "The four things they talked about were valuation, cybersecurity, insider trading and conflicts of interest," Chopper said, "so it's more of the same from 2016."

Danger of Sharing Too Much

While it is important to answer regulators' questions, respondents should take care not to be overly effusive, emphasized Powers. It is perfectly acceptable to respond to a question with, "Let me check and get back to you on that." The SEC does not have a right to demand an immediate answer, although they may push for one, and the agency cannot punish a respondent for wanting to double-check information before responding, Powers stressed.

Offering some further advice, Chopper urged respondents to anticipate that the regulators will want to interview many people at the firm. "You should have a consistent person in all of those interviews," she said. "You may hire outside counsel to do that, but you're probably going to have your chief compliance officer or in-house counsel involved in those interviews."

That consistency is useful internally when it comes to understanding the direction in which the SEC may be taking an inquiry, knowing what questions the regulators have asked employees and coaching employees about the process.

Powers' personal view that he always explains to his clients is that the SEC is not the respondent's friend, and if the agency has any grounds to bring a case, it will do so. "You need to be immediately cautious. You should never talk to the SEC without a lawyer. You should always feel free to say, 'I'll get back to you on that,'" he said.

Once an investigation is underway, it may be useful for the respondent to obtain a copy of the formal order, Powers added. This document will contain critical items of information, including the date the investigation began, which may not have been immediately evident to the respondent; the potential violations of law that the regulators are exploring; and the specific individuals whom the regulators may be looking to prosecute.

"You need to understand the exposure of your shop. Be in a position to say, 'I've looked at this,'" Powers urged.

[1] In December 2016, after the BakerHostetler panel transpired, the U.S. Court of Appeals for the Tenth Circuit (Tenth Circuit) held in Bandimere v. SEC No. 15-9586, 2016 WL 7439007 (10th Cir. Dec. 27, 2016) (Bandimere), that SEC ALJs are "inferior officers" under the "Appointments Clause" of the Constitution, and therefore must be appointed in accordance with that provision. Currently, all SEC ALJs are hired by the agency through the civil service process, thus leading the Tenth Circuit to conclude that the ALJ that presided over the Bandimere enforcement proceeding held his position unconstitutionally. The decision against Bandimere was vacated by the Tenth Circuit. The conclusion drawn by the Tenth Circuit in Bandimere is in direct opposition to the decision reached by the Court of Appeals for the District of Columbia Circuit (D.C. Circuit) in Raymond J. Lucia Cos., Inc. v. SEC, No. 15-1345, 832 F.3d 277 (D.C. Cir. 2016) (Lucia), where the D.C. Circuit ruled in favor of the SEC. In Lucia, the D.C. Circuit held that ALJs are not officers under the Appointments Clause and therefore the hiring of such individuals need not comply with the Appointments Clause.

