

22.13: Hedge Fund Industry Will Be Under Close Scrutiny by SEC Division of Enforcement

By Fredric D. Firestone and Michael A. Ungar of McDermott Will & Emery LLP

If Congress enacts legislation regulating the hedge fund industry, the SEC's activity will intensify.

The hedge fund industry is a top programmatic priority of the U.S. Securities and Exchange Commission (SEC) Division of Enforcement. The Division is currently allocating unprecedented resources to hedge fund issues and investigations. This focus will intensify if hedge fund legislation is passed.

For some time, the SEC has had concerns regarding hedge funds (as seen, for example, by the SEC's attempt to regulate the industry in 2006 under former SEC Chairman William Donaldson). The SEC's concerns include lack of transparency in hedge fund operations and market activity, potential market risks resulting from large hedge fund positions and leveraging, and hedge fund activity in opaque instruments such as credit default swaps and derivatives.

The SEC's concerns have increased as a result of the near meltdown of financial markets in 2008 (including the perception that hedge fund de-leveraging contributed to the strains on the markets), and high-profile fraudulent conduct in the Madoff debacle and the Galleon insider trading case, among others. Indeed, these same concerns animate the U.S. administration and Congress' consideration of hedge fund regulation.

Over the past year, in response to the SEC's failures in the Madoff investigation, the Division of Enforcement initiated the most sweeping changes in the way the Division operates since its inception. Many of these changes will significantly affect the hedge fund industry and investment advisers.

For example, the Division has recently formed five specialized investigative units that will focus solely on certain market participants, financial products and instruments, and large-scale market activity. Three of these units will have a specific emphasis on hedge funds, or products or conduct that may involve hedge funds:

The Asset Management Unit, focusing on hedge funds, investment advisers, investment companies and private equity funds

The Structured Product Unit, focusing on credit default swaps, collateralized debt obligations, collateralized mortgage obligations, derivatives, and other new and emerging products

The Market Abuse Unit, focusing on large-scale insider trading rings, large-cap market manipulations, and system-based and platform-driven trading violations, such as front running, best execution, abusive short selling and collusive trading

Each of these units is led by senior enforcement officers with significant experience in the respective program areas, markets and products. The units will be staffed by dozens of enforcement lawyers around the United States dedicated to unit investigations and enforcement actions. Importantly, each unit will also hire market and product experts from the industry, and resources will be expended to develop technology, including automated trading data analytics, to assist in complex trading reviews and investigations.

Hedge fund investigations by the specialized units will likely focus on a broad range of issues and perceived problematic conduct involving the following:

Fund formation, including potential misrepresentations in offering documents, false and misleading performance or marketing information, investments by non-accredited investors or unqualified purchasers, and undisclosed side letter agreements that give preferential treatment to certain investors

Performance/valuation, including potential misrepresentations as to performance or asset valuations (particularly with thinly traded securities, derivatives or complex instruments, or non-current valuations), and improper use of side pocket accounts to conceal losing positions

Custody of assets and inadequate audits, including verification of assets claimed by fund managers, potential theft of fund assets by hedge fund managers using Ponzi or pyramid schemes, and use of small or unsophisticated accounting firms that may issue faulty opinions on hedge fund financial condition

Conflict of interest/due diligence/diversification, including undisclosed financial arrangements with affiliates, side-by-side management of separate accounts, cherry-picking trades or initial public offering allocations between funds, personal investments by hedge fund managers, conducting claimed due-diligence in advance of investment decisions, and possible failure to diversify investment portfolios as represented in offering documents

Market trading, including potential insider trading, front running and market manipulation through (among other things) disseminating false rumors or marking the close in an effort to boost performance

Reporting obligations, including possible failures to comply with ownership reporting requirements such as those under Sections 13 and 16 of the Exchange Act

Broker-dealer relationships/order execution, including broker-referral arrangements directing trades or commissions to compensate for investor referrals, and possible failure to seek best execution

If Congress enacts legislation regulating the hedge fund industry, the SEC's activity will intensify. Although the parameters of such legislation are not known today, the proposals under consideration largely include an SEC registration requirement that would subject hedge fund advisers to the record-keeping, compliance, reporting, and inspection and examination regime currently in place for other regulated entities.

The SEC has already indicated that it intends to greatly increase the size of its Office of Inspections and Examinations. An active examination program for hedge funds (if legislation

is passed) and for investment advisers will result in increased referrals to, and investigations by, the Division of Enforcement.

Given the current focus by SEC Enforcement on the hedge fund industry, hedge funds should carefully review their practices, operations, compliance procedures and internal controls. This will help ensure that hedge funds are adequately prepared for the expected increased scrutiny of the industry by the SEC.

Fredric (Rick) Firestone, Partner, rfirestone@mwe.com

Business SEC Defense

Experience and Background

Rick Firestone is a partner in the law firm of McDermott Will & Emery LLP and is based in the Firm's Washington, D.C. office. He is the head of the Firm's SEC defense practice. Prior to joining McDermott, Rick was an Associate Director of the SEC's Division of Enforcement. As a senior officer of the Division of Enforcement, he was responsible for the supervision of numerous, complex investigations and enforcement actions.

Rick oversaw some of the SEC's most important and highest profile enforcement matters. He spearheaded the SEC's investigation and settlements with multiple firms in connection with the collapse of the auction rate securities (ARS) market. The ARS settlements resulted in the return of more than \$50 billion to harmed investors, the largest financial remedy in the history of the SEC. Rick was responsible for significant enforcement actions in the WorldCom and Enron matters. He also oversaw investigations and enforcement actions in all of the SEC's major program areas, including accounting, investment adviser and municipal securities fraud; violations of the Foreign Corrupt Practices Act; insider trading; misconduct by securities professionals; and conduct by accountants and independent auditors

Michael A. Ungar, Partner, mungar@mwe.com

Business SEC Defense

Experience and Background

Michael Ungar is a partner in the law firm of McDermott Will & Emery LLP and is based in the Firm's Washington, D.C. office. His practice focuses on investigations and enforcement proceedings by the Division of Enforcement of the U.S. Securities and Exchange Commission (SEC), federal criminal authorities, the Financial Industry Regulatory Authority (FINRA), the Public Company Accounting Oversight Board (PCAOB) and state securities regulators. Michael also conducts internal investigations and provides guidance on securities compliance matters.

Michael joined McDermott after 11 years in the Division of Enforcement of the SEC, including eight years as a branch chief. During his tenure at the SEC, Michael was responsible for a wide variety of enforcement matters, including the first auditor independence action brought against a foreign audit firm, the first enforcement action under

Sarbanes-Oxley's loan prohibition and the first enforcement action brought under Regulation G (relating to non-GAAP financial results).

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