

## Examinations

### SEC's Hedge Fund Focus to Include Review of Funds That Outperform the Market

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Recently, during Congressional testimony, Robert Khuzami, the Director of the Division of Enforcement (Enforcement Division) for the U.S. Securities and Exchange Commission (SEC), faced tough questions regarding the SEC's response to the Madoff scandal.<sup>[1]</sup> In response, Khuzami revealed an investigative initiative concerning hedge funds. The Enforcement Division is now focusing on hedge funds that outperform "market indexes by 3% and [are] doing it on a steady basis." Khuzami referred to such performance as "aberrational," and stated that Enforcement is "canvassing all hedge funds" for such "aberrational performance."

This initiative raises a number of questions. Should skilled portfolio managers (and their investors) bear the burden and costs of an SEC investigation just because they have returned more than the market? How and why did the Enforcement Division determine to set the threshold at three percent? Does the three percent threshold reflect "aberrational" performance, as Khuzami suggests? What is considered outperformance on a "steady basis"? Will the Enforcement Division focus on performance on a quarterly basis, or over one year, three years, or longer periods?

The hedge fund initiative will present challenging issues for the Enforcement Division, and may turn out to be far less effective in identifying potential misconduct than the SEC anticipates. It will also impose significant resource and burden costs on those hedge fund managers investigated under the initiative. Under these circumstances, we believe

the SEC should publicly outline the intended scope of its search for "aberrational performance" and consult with industry and investor groups for their perspective on the reasonableness of the three percent standard.

#### *Background: The Focus on Hedge Funds*

The hedge fund industry remains a top programmatic priority of the Enforcement Division. The Division has established a special investigative unit, the Asset Management Unit, that focuses on hedge funds. Two other special investigative units, the Market Abuse Unit and Structured Product Unit, are also looking at issues potentially involving hedge funds.

Investigations involving hedge funds will likely focus on a broad range of issues including: performance and valuation; misappropriation of assets; compliance with fiduciary duties; and market trading.

#### *Performance/Valuation*

The Enforcement Division will likely focus on representations and disclosures regarding the performance of funds and the valuation of assets. Specific concerns of the Enforcement Division may include potential misrepresentations as to investment performance, inflated asset valuations (particularly with thinly traded securities or complex financial instruments) and/or potential schemes to conceal losses (such as the improper use of "side pockets").

One recent example of this focus is the SEC's enforcement action charging hedge fund managers and related entities with defrauding investors through the use of a "side pocket."<sup>[2]</sup> The SEC alleged that the fraud was perpetrated by: (1) overvaluing illiquid fund assets placed in a "side pocket" (a type of account hedge funds use to separate investments that are often illiquid from the remainder of the fund); and (2) misappropriating other fund assets.

### *Misappropriation of Assets*

In the wake of the Madoff scandal, the Enforcement Division will continue to devote significant resources to this area. The Enforcement Division will likely focus on the verification of assets claimed by fund managers, potential theft of fund assets by managers using Ponzi or pyramid schemes, and the use of small or unsophisticated accounting firms. In addition, the Enforcement Division will likely review whether investment advisers have provided assistance to Ponzi schemes perpetrated by others.

One recent case illustrates this focus. On March 24, 2011, the SEC charged Marlon Quan and two firms he used to manage hedge funds with securities fraud violations.<sup>[3]</sup> The SEC alleged that Quan facilitated a Ponzi scheme by Thomas Petters by funneling several hundred million dollars of investor funds to the scheme, while falsely assuring investors that procedures were undertaken to protect investments. The SEC alleged that Quan engaged in a series of "round trip" transactions that created the false appearance that Petters was making payments to the funds.<sup>[4]</sup> (Petters is currently serving a 50-year prison sentence.)

### *Compliance with Fiduciary Duties*

Enforcement will continue to focus on whether investment advisers are breaching their fiduciary duties through conflicts

of interest or other improper activities. Enforcement will likely focus on the following areas: side-by-side management of separate accounts; cherry-picking trades for certain funds; personal investments by hedge fund managers; due diligence in advance of investment decisions; and possible failure to diversify investment portfolios.

An example of this focus is the SEC's action filed against ICP Asset Management, LLC and related parties.<sup>[5]</sup> The SEC alleged that ICP, a manager of collateralized debt obligations (CDOs), and the other defendants engaged in securities fraud. The complaint alleged that, by directing billions of dollars of trades at inflated prices, ICP caused certain CDOs to overpay for securities to make money for ICP and protect other ICP clients from realizing losses. In some instances, the SEC claims that ICP caused the CDOs to pay a price substantially higher than the price another ICP client paid for the security on the same day.

### *Market Trading*

Enforcement will continue to investigate whether hedge fund managers have engaged in illegal trading activities. Such conduct includes potential insider trading, front running and/or market manipulation. The numerous actions related to the Galleon investigation provide a clear indication of the SEC's push against insider trading at hedge funds.<sup>[6]</sup> Since the original case was filed, the SEC has charged 28 defendants.<sup>[7]</sup>

The Enforcement Division's stated goal is to be proactive in identifying potential misconduct by hedge fund managers.<sup>[8]</sup> Traditionally, Enforcement was reactive to potential issues, relying on the SEC's examination program, media reports, self-reporting and tips to initiate investigations. The desire to be more proactive may be the impetus for the hedge fund initiative.

Whether the initiative will be more effective than traditional methods for identifying misconduct remains to be seen.

### *The Hedge Fund Initiative*

Under its recently disclosed initiative, the Enforcement Division will first attempt to identify hedge funds that are outperforming the “market.” The first stage of the initiative will likely be a screening process in which the staff will start with a large universe of funds and then try to narrow the scope based on certain criteria. The Enforcement Division will likely access services that track the performance of certain hedge funds, and use these databases to search for funds that meet specific criteria. Additionally, the Enforcement Division may send requests to numerous hedge funds seeking information related to investment performance. This stage will require the Enforcement Division to make difficult assessments.

To begin with, the Enforcement Division will need to determine the appropriate benchmark to measure whether a specific fund has outperformed. While some hedge funds may utilize benchmarks, others do not. But this information is not publicly available. To the extent the Enforcement Division uses market indices, as Khuzami’s testimony suggests, this could be problematic. Broad market indices, such as the S&P 500, may be an inappropriate benchmark for many funds, which have unique investment strategies, broad investment discretion (e.g., commodities, equities, bonds, foreign investments), and have the ability to hold far larger positions than a typical mutual fund. In addition, at the discretion of a fund manager, funds can utilize a wide variety of strategies including leverage, short positions, futures or switching to cash. All of these factors can enable a hedge fund to significantly outperform stock market indices. For

example, fund managers who anticipated the financial crisis outperformed the major stock market indices during 2007 and 2008, and probably for the last four years.<sup>[9]</sup> Given the lack of public information on what fund managers have invested in, what benchmarks (if any) they use, or what strategies they have used in the past, determining the appropriate benchmark may be far more complicated than the SEC anticipates.

At the screening stage, the SEC will also have to determine what period of outperformance is sufficient to warrant additional investigation. Interestingly, Berkshire Hathaway Inc. recently reported that it handily beat the S&P 500 over the last 46 years – 20 percent annualized returns versus 9.4 percent annualized returns for the S&P 500.<sup>[10]</sup> Thus, not only did Berkshire beat the S&P 500 on a “steady basis,” it did so by far more than the SEC’s three percent threshold for “aberrational performance.” Berkshire also beat the S&P 500 during the last five years by over seven percent. Successful investment performance over an extended period does not, and should not, suggest potential misconduct. Indeed, given that the S&P 500 returned negative ten percent for the ten year period ending on December 31, 2009,<sup>[11]</sup> funds that made sound investment decisions, such as shorting the market or investing a large portion of assets in bonds, likely outperformed the broad market by far more than the three percent threshold. Accordingly, there may be far more hedge fund managers that have outperformed the broad market than the Enforcement Division anticipates. This will make the screening process more difficult, by requiring the Enforcement Division, at an early stage, to try to distinguish between superior performance that resulted from potential misconduct as opposed to investment skill.

Once the Enforcement Division completes the screening phase, it will use that information to determine where it should focus investigative resources. In determining whether a particular fund warrants further investigation, the Enforcement Division may consider other issues, such as the size, reputation and experience of the fund's audit firm, fund administrator and prime broker. The Enforcement Division will view investment managers that maintain custody of investor assets as a red flag.<sup>[12]</sup> If the Enforcement Division determines that a full-fledged investigation is warranted, it will likely focus on whether the outperformance resulted from any misconduct, such as insider trading, improper valuation of investments, manipulative trading and/or a Ponzi scheme.

As discussed above, the Hedge Fund Initiative raises several difficult issues centered on market performance, and risks imposing an "SEC investigation tax" on legitimate entrepreneurial success. We recommend that the SEC first publicly outline the intended scope of its search for "aberrational performance," and consult with industry and investor groups for their perspective on the reasonableness of the three percent standard. While concept releases and similar efforts are not normally undertaken with respect to Enforcement Division initiatives, such consultation would, in our view, improve the Enforcement Division's efforts in the long-term, given the wide-ranging application of this initiative, while appropriately limiting the resource and cost burden imposed on the industry. Such efforts would also be consistent with Chairman Shapiro's record of fostering transparency.

### *Conclusion*

Given the aggressive enforcement environment facing hedge funds, investment managers that have outperformed

the market should be aware that the SEC may soon come knocking on their door. These investment professionals should be prepared to explain to the Enforcement Division the specific strategies that enabled the superior investment returns. In any event, investment advisers should take this opportunity to take a fresh look at their policies and procedures, especially, those relating to: (1) the documentation of investment decisions; (2) valuation of assets; and (3) trading of securities.

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<sup>[1]</sup> Oversight of the Securities and Exchange Commission's Operations, Activities, Challenges and FY2012 Budget Request Before the H. Comm. on Fin. Servs., 112th Cong. 1 (March 10, 2011) (Testimony of Robert Khuzami, Director of the SEC's Division of Enforcement).

<sup>[2]</sup> *SEC v. Paul T. Mannion, Jr., Andrew S. Reckles, PEF Advisors LLC, and PEF Advisors Ltd.*, Civil Action No. 10-CV-3374 (N.D. Ga.); SEC Litigation Release No. 21699 (Oct. 19, 2010). See also "SEC Brings Civil Securities Fraud Action Against Principals of Hedge Fund Palisades Master Fund, Alleging Fraud, Self-Dealing, Misuse of Fund Assets and Use of a 'Side Pocket' to Misrepresent the Fund's Value to Its Investors," *The Hedge Fund Law Report*, Vol. 3, No. 42 (Oct. 29, 2010).

<sup>[3]</sup> *Securities and Exchange Commission v. Marlon Quan, Acorn Capital Group, LLC and Stewardship Investment Advisors, LLC, Defendants and Asset Based Resource Group, LLC and Florene*

*Quan, Relief Defendants*, Civil Action No. 11-CV-00723 (D. Minn.); SEC Litigation Release No. 21906 (Mar. 28, 2011).

<sup>[4]</sup> See also *SEC v. Juno Mother Earth Asset Management, LLC, Eugenio Verzili and Arturo Allan Rodriguez Lopez a/k/a Arturo Rodriguez, Defendants*, Civil Action No. 11-CV-1778 (S.D.N.Y. March 15, 2011) (alleging scheme to defraud clients by misappropriating client assets, inflating assets under management and filing false information with the SEC); “Twelve Operational Due Diligence Lessons from the SEC’s Recent Action against the Manager of a Commodities-Focused Hedge Fund,” *The Hedge Fund Law Report*, Vol. 4, No. 11 (Apr. 1, 2011).

<sup>[5]</sup> *SEC v. ICP Asset Management, LLC, ICP Securities, LLC, Institutional Credit Partners, LLC, and Thomas C. Priore*, Civil Action No. 10-CV-4791 (S.D.N.Y. June 21, 2010); SEC Litigation Release No. 21563 (Jun. 22, 2010). See also “In Enforcement Action Against Investment Adviser ICP Asset Management, LLC, SEC Alleges More than \$1 Billion of Improper Trades, Trades at Inflated Prices and Other Fraudulent Conduct in Connection with ICP’s Management of Triaxx CDOs,” *The Hedge Fund Law Report*, Vol. 3, No. 26 (Jun. 1, 2010).

<sup>[6]</sup> See, e.g., SEC Litigation Release No. 21802 (Jan. 10, 2011); SEC Press Release 2009-221 (Oct. 16, 2009).

<sup>[7]</sup> In a parallel criminal proceeding, the United States Attorney’s Office for the Southern District of New York brought criminal charges against 14 defendants in the fall of 2009.

<sup>[8]</sup> See, e.g., Statement of Robert Kaplan, Co-Chief of Asset Management Unit, January 13, 2010 (“[W]e will develop and utilize proactive investigative approaches . . .”).

<sup>[9]</sup> One recent book focused on several hedge fund managers who anticipated the financial crisis and reaped huge returns for their investors through positions in credit default swaps. See Michael Lewis, *The Big Short: Inside the Doomsday Machine* (2010).

<sup>[10]</sup> Berkshire Hathaway 2010 Annual Letter to Investors.

<sup>[11]</sup> USA Today, “Will Stocks’ ‘Lost Decade’ Usher in Another Bull Market?” (Jan. 4, 2010).

<sup>[12]</sup> As Khuzami recently testified, “[w]e understand that investment advisers who self-custody their own assets are a potential warning flag.” Oversight of the Securities and Exchange Commission’s Operations, Activities, Challenges and FY2012 Budget Request Before the H. Comm. on Fin. Servs., 112th Cong. 1 (March 10, 2011) (Testimony of Robert Khuzami, Director of the SEC’s Division of Enforcement).