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Looking Behind the Curtain – How to Respond to the New Era of SEC Enforcement Activity

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I. Introduction

For the past two years, private equity and hedge funds have been facing mounting litigation from the U.S. Securities and Exchange Commission ("SEC"). In addition to its recent prosecution of major fraud and insider trading schemes at, *e.g.*, Madoff, Stanford and Galleon, the SEC has initiated a wave of litigation against hedge fund and private equity managers that never would have been brought in prior years. For example, in August 2011, the SEC took unprecedented action against Matthew Crisp, a consulting partner in private equity fund Adams Street Partners, LLC, for allegedly usurping opportunities belonging to the consultant's private equity fund investors. In November 2011, the SEC filed a case against private equity manager Patrick Rooney and his firm Solaris Management, LLC for directing investments to a business where Rooney served on the board of directors – a posting typical for many private equity firms.

What's leading the charge behind the SEC's unprecedented actions? Contrary to the prevailing conventional wisdom, the answer has little to do with the 2010 enactment of Dodd-Frank. (*See* Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") (Pub. L. 111-203, H.R. 4173).) While that statute created new compliance and registration

criteria, it did not widen the SEC's inherent power to prosecute perceived breaches of duty by investment professionals in selling, buying, or advising about securities. And, empirically, long before Dodd-Frank, the SEC had already begun a substantial increase in litigation against hedge fund and private equity firms and professionals.

This Chapter examines the origins of the new SEC enforcement mandate, what private equity and hedge fund managers should expect out of the regime, and how to prepare for and react to these events.

II. Issues That Are Shaping The Current Regulatory Environment

There are three key factors shaping the current regulatory environment. First, there are domestic political issues as a result of the Madoff and Stanford scandals. Second, the debt crisis in Europe will impact the regulatory environment in the U.S. Finally, the U.S. economy plays a role in shaping the current regulatory environment.

A. The U.S. Political Climate

The political landscape in the United States has changed significantly as a result of the Madoff and Stanford scandals and the collapse of the financial markets in 2008. Politicians reacted in an effort to assure the public they were addressing the problem. Regulators have taken every opportunity publicize their efforts to crack down on Wall Street.

1. The SEC Pledges To Pull Back The Curtain On The Hedge Fund Industry

On October 16, 2009, the Securities and Exchange Commission and the U.S. Attorney's Office for the Southern District of New York jointly announced insider trading actions against Raj Rajaratnam of the Galleon Group hedge fund management firm. Earlier this year, a federal jury found Rajaratnam guilty on all 14 counts of insider trading. (*See* Grant McCool and Basil Katz, "Rajaratnam Convicted on all Insider Trading Charges," BLOOMBERG (May 14, 2011), available at http://www.reuters.com/article/2011/05/11/us-galleon-rajaratnam-idUSTRE74A3XM20110511.) Rajaratnam was recently sentenced to an 11 year prison term – a

record for insider trading – and was fined $10 million. (*See* Aaron Smith and Hussein Saddique, "Galleon Manager Rajaratnam Sentenced," CNN MONEY (October 14, 2011), available at http://money.cnn.com/2011/10/13/news/companies/insider_trading_raj_rajaratnam/index.htm.) The fall-out from the Galleon scandal continues. Rajat K. Gupta, a former director at Goldman Sachs was arrested on October 26, 2011 on charges of conspiracy and securities fraud. (*See* Azam Ahmed, "With Gupta's Arrest, Insider Inquiry Goes Beyond Wall St.," NEW YORK TIMES DEAL BOOK (October 26, 2011), available at http://dealbook.nytimes.com/2011/10/26/gupta-surrenders-to-authorities-on-insider-trading/.) The same day, the SEC filed an insider trading complaint against Gupta. (*See* SEC Litig. Release No. 22140 (October 26, 2011), available at http://www.sec.gov/litigation/litreleases/2011/lr22140.htm.)

At the press conference announcing the filing of the Galleon case, Robert Khuzami, Director of the SEC's Division of Enforcement, proclaimed that the SEC is "committed to pulling back the curtain on hedge fund operations and taking a close look at their activity." (*See* Robert Khuzami, SEC Dir. Of Enforcement, Speech by SEC Staff: Remarks at Press Conference (October 16, 2009), available at http://www.sec.gov/news/speech/2009/spch101609rk.htm.) Two weeks later, SEC Chairman Mary Schapiro touted the agency's efforts to restore public confidence and re-energize the Division of Enforcement. In her speech, Chairman Schapiro emphasized that the SEC had created a new Division of Risk, Strategy and Financial Innovation to enhance expertise within the agency by hiring people with "current street experience" in hedge funds. (*See* Mary Schapiro, SEC Chairman, Speech by SEC Chairman: The Road to Investor Confidence (October 27, 2009), available at http://www.sec.gov/news/speech/2009/spch102709mls.htm.) The Chairman added that one of the most significant regulatory gaps relates to hedge funds "which have flown under the regulatory radar for far too long." (*Id.*)

Over the past two years, the SEC restructured its Division of Enforcement and created "specialty units" to enhance the staff's expertise in specific areas including private equity and

hedge funds. Both the SEC's Asset Management Unit and Market Abuse Unit have promised to devote substantial resources to looking closely at insider trading and other unlawful activity the hedge fund industry. (*See* Nick Paraskeva, "SEC Market-Abuse Chief Takes Trader-Based Approach," REUTERS (February 25, 2011), available at http://www.reuters.com/article/2011/02/25/us-financial-regulation-abuse-idUSTRE71O4ZC20110225.)

2. SEC'S Enforcement Statistics Confirm the Trend

On November 9, 2011, the SEC announced its enforcement statistics for the fiscal year ended September 30. The SEC filed a record-breaking 735 enforcement actions, obtaining $2.8 billion in civil penalties and disgorgement for the year. (*See* SEC Release No. 2011-234, available at http://www.sec.gov/news/press/2011/2011-234.htm.) The cases addressed a broad variety of conduct, but several notable actions were tied to the private equity and hedge fund industry. For the third consecutive year, there was an increase in insider trading cases with 57 actions filed. (*See* Year-by-Year SEC Enforcement Actions, available at http://www.sec.gov/news/newsroom/images/enfstats.pdf.) The SEC also obtained 18 judgments in enforcement actions related to the SEC's investigation of Galleon Management.

While the Galleon scandal garnered numerous headlines over the past year, the SEC also focused on many smaller cases involving the investment management industry. In total, the agency brought 146 enforcement actions related to investment advisers and investment companies, representing an almost 30 percent increase over the prior fiscal year. (*Id.*) That increase follows on the heels of a 47 percent increase in the number of cases the SEC brought against investment advisers in fiscal year 2010 as compared to 2009. (*Id.*)

3. Contrary To Conventional Wisdom, Dodd-Frank Is Not Driving The Regulatory Trend To Pursue Private Equity and Hedge Funds

On July 21, 2010, President Barak Obama signed the Dodd-Frank Act into law. On May 25, 2011, the SEC adopted rules to implement a whistleblower program pursuant to Section 922

of the Dodd-Frank Act that rewards individuals who provide the SEC with tips that lead to successful enforcement actions. In cases where monetary sanctions are greater than $1 million, a whistleblower may receive between 10 percent and 30 percent of the total sanctions collected. In its relatively brief tenure, the whistleblower program has received 334 tips, and no whistleblower awards were made during the 2011 fiscal year. (*See* U.S. Securities and Exchange Commission Annual Report on the Dodd-Frank Whistleblower Program Fiscal Year 2011, available at http://sec.gov/about/offices/owb/whistleblower-annual-report-2011.pdf.)

On June 22, 2011, the SEC announced that it had adopted rules that require certain advisers to hedge funds and other private funds to register with the SEC. Generally, under the new SEC rules, fund advisers with over $100 million in assets under management ("AUM") and will have to register with the SEC. Fund advisers with between $25 million and $100 million in AUM must register with their state unless exempt from state registration, or if the state does not call for examination of such advisers.

Both the whistleblower program and the new registration rules have been the subject of extensive commentary and debate. Contrary to the views of many, the new rules are not driving a trend toward increased scrutiny of private equity and hedge funds. Rather, they are the result of Government's and the public's ongoing interest in scrutinizing funds in the wake of the Madoff and Stanford scandals. The statistics bear this out. Dodd Frank became law in July 2010, two months before the end of the SEC's 2010 fiscal year. According to the statistics, the SEC brought 47 percent more cases against investment advisers than it did in fiscal 2009. (*See* Year-by-Year SEC Enforcement Actions, available at http://www.sec.gov/news/newsroom/images/enfstats.pdf.) Likewise, the rules implementing the whistleblower program were adopted in May 2011, four months before the end of the SEC's 2011 fiscal year. Yet, the SEC brought nearly 30 percent more cases in fiscal 2011 than it did in 2010. The tremendous increase in enforcement activity was underway long before Dodd Frank had any appreciable impact on the industry.

When the SEC adopted the registration rules, SEC Chairman Mary Schapiro essentially

reiterated what she said nearly two years beforehand. "[O]ur proposal will give the Commission, and the public, insight into hedge funds and other private fund managers who previously conducted their work under the radar and outside the vision of regulators." (*See* SEC Press Release No. 2011-133, available at http://www.sec.gov/news/press/2011/2011-133.htm.) The SEC's view of hedge funds as "flying under the radar" has been in play long before the passage of Dodd Frank or the rules implementing its provisions. This view of private equity funds as hidden and impervious to scrutiny is clearly the driving force behind the massive increase in enforcement actions. Dodd Frank is merely a recent development in a trend that started two years ago.

B. Foreign Issues Impacting The Private Equity Market

MF Global Holdings filed for bankruptcy protection on October 31, 2011. While it will take some time for all the facts to be known, generally, the company gambled on bonds floated by various European nations in 2010. MF Global's bets were unsuccessful as yields on the sovereign debt it held collapsed, taking the bond prices down. In addition, MF Global has been unable to locate hundreds of millions of dollars in missing customer funds.

On October 31, 2011, the Securities Investor Protection Corporation (SPIC) announced that it was initiating the liquidation of MF Global under the Securities Investor Protection Act. (*See* SPIC News Release, available at http://www.sipc.org/media/release31Oct11.cfm.) That same day, the CFTC and SEC issued a joint release stating that the agencies felt that the SIPC-led bankruptcy "would be the safest and most prudent course of action to protect customer accounts and assets." (*See* SEC Press Release No. 2011-230, available at http://www.sec.gov/news/press/2011/2011-230.htm.)

There will be inevitable questions about how MF Global could have failed while so many regulators were policing the industry. Hundreds of millions of dollars of customer money is missing and MF Global's chief, Jon Corzine, testified before Congress that he does not know where the money is located or why the accounts were not reconciled. (*See* Sarah N. Lynch, "MF

Global's Corzine: I did not intend to break rules," REUTERS (December 8, 2011), available at http://news.yahoo.com/corzine-remarks-panel-mf-global-082044647.html.) Given the massive losses and global impact of MF Global's collapse, it would be surprising to see the SEC sit quietly on the sidelines while the liquidation proceeds, notwithstanding their public support of the SIPC liquidation. Indeed, the SEC is keenly aware that investors are typically the last to recover losses in bankruptcy proceedings because investors are usually unsecured creditors who recover after secured creditors have been paid. The CFTC's plan of action seems less clear in light of CFTC Chairman Gary Gensler's decision to recuse himself from the investigation because of his longstanding ties to Jon Corzine who was the chairman and senior partner at Goldman Sachs Group when Gensler worked there.

MF Global is not the only casualty of the economic turmoil in Europe. The U.S. stock market has experienced a great deal of volatility as the euro-zone countries struggle to design policies to contain the debt crisis. Investor uncertainty has been compounded by political volatility in countries such as Greece and Italy which have experienced a great deal of upheaval resulting from the implementation of so-called austerity measures. Europe's difficulties will undoubtedly affect other private funds exposed to European debt or that invest in European markets. As a result, there will increased litigation involving funds here in the U.S. Several class action cases have been already been filed against MF Global and more are likely in the future. Other funds that experience significant losses based on European debt may face similar litigation by investors or other third parties.

Politicians and regulators are going to take an even closer look at the investment management industry as a result of the MF Global scandal. Daniel Roth, chief executive of the National Futures Association, plans to offer possible reforms for Congress to consider. (*See* "MF Global Collapse Prompts Call for Rule Overhall," REUTERS (December 8, 2011), available at http://www.cnbc.com/id/45596650.) Noting that investors have suffered from a breakdown in the regulatory process, Roth plans to propose reforms including storing customer money with a third-

party custodian instead of with a futures brokerage directly, and having self-regulatory organizations perform surprise spot-checks more frequently to confirm account balances. (*Id*.) The search for the missing money has raised serious questions about the effectiveness of U.S. futures regulations in protecting customer money, which is required to be segregated from firm funds. (*Id*.) Only time will tell whether the political forces that lead to the passage of the Dodd-Frank Act will lead to additional legislation. If past experience serves as an indicator, however, additional legislation seems likely.

C. The U.S. Economy

The current economic picture in the U.S. has left investors feeling uncertain, affecting trends in the private equity space. Periods of strong economic growth tend to alleviate deficits as more revenue flows into the Government's coffers. Also, when people are doing better financially, they tend to be more willing to make investments.

Both the housing and investment markets are depressed at this time and investors are faced with uncertainty. The Dodd-Frank Act has also added to the uncertainty as investment advisers with AUM of more than $100 million prepare to register with the SEC. Both investors and venture capital/private equity funds do not know what the new environment is going to look like once they register—i.e., will they be subject to examinations, what the examinations will look like, and how will they interface with regulators? The focus, however, should not be on registration alone. While registration imposes certain burdens on funds, the SEC will continue to prosecute cases involving unregistered advisers. No private equity or hedge fund is immune from scrutiny.

Given the SEC's pronouncements about looking behind the curtain and looking at the tremendous increase in the number of SEC cases against investment advisers over the past two years, it is clear that an ever-increasing number of private equity and hedge funds, both large and small, are going to be the subject of SEC interest. The threat of regulatory action and the costs of responding will be of concern to many investors.

III. Examining The SEC's Recent Enforcement Proceedings And Their Impact.

The Galleon insider trading cases continue to make headlines. However, the SEC's recently released enforcement statistics reflect a sizeable increase in the number of actions against investment managers over the past two years. Given the recent global and local events affecting the private equity industry, it is very likely that there will continue to be an uptick in SEC enforcement actions over the next few years. If recent enforcement actions are any indication, the SEC is now brining more cases against investment advisers that previously would have been resolved through routine litigation among fund members.

A. Litigation Involving The Private Equity/Venture Capital Markets – The SEC's New Focus On Hedge Fund And Private Equity Managers.

1. SEC vs. Solaris Management

On November 18, 2011, the SEC brought a federal court action against Patrick G. Rooney. (*See SEC v. Patrick G. Rooney and Solaris Management, LLC*, Case No. 1:11-cv-08264 (N.D. Ill.).) According to the SEC's complaint, Rooney and Solaris Management were advisors to the Solaris Opportunity Fund, LP, a hedge fund, which they defrauded by using the fund's assets to further their own interests. (A copy of the complaint is available at http://www.sec.gov/litigation/complaints/2011/comp22167.pdf.) Specifically, the SEC alleges that Rooney and Solaris Management invested over $3.6 million of the hedge fund's money in Positron Corporation, a financially troubled company of which Rooney was Chairman. Rooney did not disclose to investors that he had been Positron's Chairman since 2004. According to the SEC's complaint, Rooney misled investors about the timing of when he became Chairman and the reasons for which he became Chairman when he disclosed his role at Positron in 2009. The result was that the Positron investments harmed Solaris by concentrating fund investments in an undiversified and non-liquid investment fund in a cash-poor company that had a track record of losses. The SEC alleges that Rooney and Solaris engaged in self-dealing in violation of their fiduciary duties by investing fund assets in a company in which Rooney had personal and

economic ties. The SEC charged Rooney and Solaris with, among other things, violations of Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 ("Advisers Act"), which prohibits fraud by investment advisers; and Section 206(4) of the Advisers Act, which prohibits fraud by investment advisers to pooled investment vehicles.

It is well-established that a breach of fiduciary duty by an investment adviser can violate Section 206 of the Advisers Act. (*See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-192 (1963) (advisers owe fiduciary duty to deal with their clients in utmost good faith and complete candor.)) The Courts have found violations of Section 206 of the Advisers Act where an adviser comingles client assets with the adviser's assets, where the adviser has operated a Ponzi scheme, or otherwise secretly profits from clients. (*Capital Gains*, 375 U.S. at 196-97; *also see United States v. Elliott*, 62 F.3d 1304 (11th Cir. 1995), *amended* 82 F.3d 989, *cert. den.*, 519 U.S. 859 (ponzi scheme violated Section 206); *SEC v. Slocum, Gordon & Co.*, 334 F. Supp.2d 144 (D.R.I. 2004) (commingling clients' assets with firm's).)

If the facts as alleged by the SEC are true, then Rooney and Solaris violated the Advisers Act. Traditionally, however, the SEC has focused on breaches of fiduciary duties that have resulted in tangible harm to investors. While the SEC's complaint against Rooney alleges misuse of investor funds by directing investments to Positron, there are no allegations that Rooney or Solaris stole investor funds, nor are there allegations that investors lost money. In essence, the *Rooney* case involves a garden variety conflict of interest where the individual is not alleged to have been personally enriched through his misconduct. The *Rooney* case should serve as a warning to all investment advisers who sit on boards that they too could become the target of an SEC investigation or enforcement action, particularly if they advise funds that have invested in business where the adviser serves on the board of directors or in some other official capacity.

2. In The Matter Of Matthew Crisp (SEC Administrative Proceeding)

On August 29, 2011, the SEC announced the issuance of an Order Instituting Public Administrative and Cease-and Desist Proceedings against Matthew Crisp ("OIP"), available at

http://www.sec.gov/litigation/admin/2011/34-65217.pdf. According to the OIP, the SEC's Division of Enforcement alleges that between 2006 and 2008, Crisp exploited conflicts of interest for his personal gain while working as a partner of Adams Street Partners, LLC, a registered investment adviser to multiple private equity funds. According to the Division of Enforcement, Crisp secretly formed a private investment vehicle with a friend. He then directed an investment opportunity away from Adams Street in favor of the investment vehicle he formed. The Division of Enforcement alleges that Crisp concealed his conduct. He subsequently obtained a payment of $150,000 during a later buyout of the same private company when the money should have gone to Adams Street to reduce the fees due from its private equity funds. The OIP alleges that Crisp also pursued an investment opportunity in a private company in which Adams Street's funds were invested. He initially profited by more than $2 million at the expense of Adams Street but was forced to repay the money prior to the SEC's action. Crisp is charged with violating Sections 206(1), 206(2) and 206(4) of the Advisers Act.

Like the *Rooney* case, the Crisp matter appears to be a routine conflict of interest dispute that could have been resolved among the managers. Indeed, according to the OIP, Crisp returned the profits from the allegedly tainted transactions. Additionally, the conduct in question occurred largely between 2006 and 2008. Still, the SEC's Division of Enforcement sought to lift this particular matter to the level of an enforcement action.

B. The Impact Of Recent SEC Enforcement Actions

Looking at the SEC's enforcement statistics for its fiscal year ended September 30, 2011, there are examples of traditional insider trading cases, many of which involve private equity or hedge funds. The SEC has made it very clear that it will continue to aggressively pursue insider trading within the private equity and hedge fund space. As the *Rooney* and *Crisp* cases show, however, there is also stepped-up interest in more mundane transactions — i.e., transactions that involve either business disputes among partners or conflicts of interest. These cases should give everyone in the investment management industry pause. The SEC is indeed living up to its much

proclaimed pronouncement that it is going to "look behind the hedge fund curtain" and take action, even in situations where the conduct is old and the dispute might be better resolved through traditional litigation or some other form of conflict resolution among the managers. In the current environment, no one in the private equity or hedge fund space should think that they will be free from scrutiny. Recent cases reflect that they are not.

IV. New Compliance Changes Facing Private Equity Funds

One challenge that investment funds face in this new environment is how to go about developing compliance programs that comply with the Dodd-Frank Act. In addition to requiring an expanded class of investment advisers to register with the SEC, the Dodd-Frank Act also requires registered entities to implement written compliance policies and procedures and to perform annual compliance assessments. Additionally, registered advisers will be subject to SEC examinations. To succeed, registered advisers will have to invest resources in technology to create or upgrade IT systems that will be able to address document management, email retention and oversight of third-party service providers, among other things. A robust IT system will also be essential to a fund's internal efforts to address problems when they arise, particularly if an internal or independent investigation becomes necessary. Finally, an appropriate IT system will help investment managers respond to SEC inquiries as well. When the SEC arrives, the staff will expect funds to produce large amounts of information in a very short period of time.

Adding to the challenge is the fact that there is no rule book for investment advisers to follow. Broker-dealers are regulated by FINRA which promulgates rules. Broker-dealers are also subject to NASD and NYSE rules. It is a much simpler task to develop compliance programs designed to adhere to a relatively fixed set of rules than to develop a program designed to avoid more nebulous concepts like breaching fiduciary duties.

While the path forward for private equity funds may be less clear, there are certain concrete steps funds can take to foster a culture of compliance. For example, hiring a compliance officer or independent ombudsman to filed whistleblower complaints and maintain confidentiality

would set a compelling message about compliance. Prior to the implementation of the Dodd-Frank whistleblower system, industry insiders argued vociferously that whistleblowers should first be required to disclose wrongdoing internally. The SEC did not adopt the proposed requirement. Nevertheless, funds will be well served by providing a forum for whistleblower complaints. Some whistleblowers will still go directly to the regulators in the hopes of collecting a bounty. However, an internal whistleblower program will help convince regulators that a fund takes compliance seriously. Additionally, it can serve as a vehicle for funds to gather information and increase the level of cooperation when regulators investigate potential wrongdoing.

Private equity and hedge funds also need to consider what management can do to minimize the potential for conflicts of interest. For example, if advisers are conducting transactions with affiliated entities, then management should be sure to disclose the transactions to investors. If advisers have soft dollar arrangements, then they need to make appropriate disclosures to investors. Private equity firms can adopt policies governing gifts and entertainment. Likewise, firms should adopt and enforce trade allocation rules to ensure that trades are allocated fairly among different funds.

The evidence is unequivocal that the SEC continues to ramp up its interest in pursuing private equity and edge funds. Public statements from SEC officials, enforcement statistics, and recent cases in the private equity space bear this out. Understandably, there is a great deal of discussion about compliance for registered advisers. As noted above, however, unregistered advisers are also subject to enforcement actions by the SEC. As such, even unregistered entities should adopt compliance measures in order to detect possible misconduct.

V. Compliance Alone Is Not Sufficient To Respond To The New Era Of Scrutiny

While compliance is significant, it is not the primary challenge facing the private equity industry. The real task for funds is to devise a proactive strategy to address problems as they arise. In this environment, an effective strategy must be focused on determining the right type of investigation to gather facts, obtaining the facts quickly, maintaining the confidentiality of the

fact-gathering process, and determining whether to self-report to regulators. Finally, private equity and hedge funds should adopt internal whistleblower programs that maintain witness confidentiality as a tool to gather information about wrongdoing, convince regulators that a fund takes compliance seriously, and increase the level of cooperation when regulators investigate potential wrongdoing.

A. When A Problem Is Suspected, Involve Legal Counsel So That The Process Is Protected By The Attorney-Client Privilege

What should managers do when they suspect or know that something is amiss, be it an innocent mistake in calculating a portfolio's value, or misconduct amounting to fraud or breach of fiduciary duties? The first step is to be proactive and strategic. Do not waste time contemplating all the possible options. More importantly, do not solicit the advice of people outside of the fund. Rather, at the first hint of an issue, it is important to involve in-house or outside counsel in the discussion so that the fact-gathering process is protected by the attorney-client privilege. This is critical because when regulators get involved, lawsuits by business partners, investors or other third parties often follow, and funds do not want to find themselves in the position of having to disclose all their communications about internal problems during litigation.

B. Retain Outside Counsel To Conduct An Independent Investigation If Intentional Wrongdoing Is Suspected

The next step is to decide whether to conduct an internal investigation or retain outside counsel to conduct an independent investigation. This decision will largely be guided by the information obtained in the early stages of the fact-gathering process. Often, it becomes clear that the issue is a simple mistake. Small mistakes can often be addressed through an internal investigation because they can be remedied by a legal memo to the file in conjunction with some corrective action designed to avoid similar errors in the future.

Generally, regulators are interested in conduct where there is an intent to circumvent rules or violate the law. In addition, often minor misconduct or technical violations of the law will attract a regulator's interest where there has been an effort to cover up the wrongdoing. If a

private equity or hedge fund suspects intentional misconduct, it is best to retain independent counsel to conduct the investigation. Often investigations that do not appear independent are greeted with skepticism by regulators. When the SEC or CFTC becomes involved, it is important to present them with independent findings. Otherwise, there is a risk that the SEC or CFTC will reinvent the wheel and conduct a new, full-blown investigation, which can become very expensive.

C. Decide Whether To Report Wrongdoing To Regulators

At the end of either an internal or independent investigation, funds will need to decide whether to disclose the investigation and its findings to regulators. There is no legal requirement to self-report which creates a tough decision for funds and their counsel. Some will argue that there should be no disclosure unless there is a strong likelihood that regulators would uncover the issue on their own. Adherents to this view believe that the SEC and CFTC are imposing harsher sanctions even on businesses that cooperate extensively with regulators. Further, they believe that if their cooperation is not going to be sufficiently rewarded, then there is no real benefit to self-reporting.

Others believe that self-disclosure is the more prudent course. They would argue that there are instances where cooperators have received no sanctions at all and that the ensuing enforcement actions have been limited to the actual wrongdoers. They would also note that even where there are sanctions against the disclosing entity, those sanctions are reduced as an acknowledgement of cooperation. Historically, the SEC has rewarded cooperation with lesser sanctions. There is no cookie-cutter answer for the dilemma of whether to disclose. Rather, funds and their counsel will have to carefully balance the risks and benefits of self-reporting based on the conduct involved.

D. Use Confidentiality Agreements With Members, Partners, Employees And Third Parties

Funds should expect scrutiny during legal disputes. As the *Rooney* and *Crisp* cases

demonstrate, garden variety conflicts of interest can trigger an enforcement action even where there is no private litigation. Private litigation involving alleged breaches of fiduciary duty may trigger investor lawsuits and may also attract attention from the SEC. While there are few limits on what information the SEC can seek in its investigations, funds should be mindful of protecting the confidentiality of their information at every turn, particularly where there is a chance that a current dispute will lead to further litigation by investors or other third parties. Funds should have ironclad confidentiality or non-disclosure agreements with their members or partners, employees and third parties with whom they do business. Those agreements should contain arbitration clauses for all disputes. Disputes in arbitration are often not as confidential as people assume, but in the context of a confidentiality agreement, it will be easier to safeguard confidential information. Again, it may not be possible to limit the disclosure of confidential information to regulators, but funds are well-advised to limit the ability for third parties to access confidential information.

E. Create An Internal Whistleblower Program

Finally, funds must be prepared to address whistleblowers. As noted above, registered and unregistered investment advisers should create an internal whistleblower program. While the current SEC rules to not require a whistleblower to first report wrongdoing to the company, the rules could change. In a recent letter to Congress, Chairman Schapiro said the current whistleblower program is yielding "significant benefits" and should not be changed. (*See* Andrew Ackerman, "Congress shouldn't alter whistleblower plan: SEC," MARKET WATCH (December 14, 2011), available at http://www.marketwatch.com/story/congress-shouldnt-alter-whistleblower-plan-sec-2011-12-14.) Chairman Schapiro's letter addresses an anticipated vote in Congress that would require changes to the whistleblower program, including a requirement that whistleblowers first report misconduct to the company. (*Id.*) Chairman Schapiro expressed concern that the proposed requirement would "have a chilling effect" on whistleblowers by undermining their anonymity. (*Id.*) While the proposed legislation will not succeed in the

current Senate, 2012 is an election year and the balance of power in Congress could change. Funds that adopt internal whistleblower programs that protect anonymity will find themselves ahead of the curve when it comes to uncovering wrongdoing.

VI. Conclusion and Key Takeaways

Contrary to the conventional wisdom, Dodd Frank is not ushering a new era. Rather, it is a political and regulatory response to a trend born in the wake of Madoff and Stanford. Over the past two years, there has been a phenomenal increase in the number of enforcement actions brought by the SEC against private equity and hedge funds. A substantial portion of that increase occurred before Dodd Frank became law.

Looking ahead, the two-year trend of increased litigation against private equity and hedge funds will certainly continue. The recent collapse of MF Global will only add fuel to the fire. More and more business disputes involving alleged breaches of duty, especially perceived conflict of interest, will turn into enforcement actions brought in federal court or administrative proceedings before administrative law judges.

Given the regulatory changes in this area, compliance is fundamental—particularly compliance in areas such as conflicts of interest and insider trading. Even more important, however, is the need for a proactive strategy to respond to the current environment. Many private equity funds are not used to dealing with the enforcement side of the SEC and may not appreciate the impact of a full-blown investigation. If that investigation results in an enforcement action, the consequences can be devastating for the individuals involved. Careers and reputations can be ruined. The taint associated with fraud charges often does not go away even when people beat the charges. In addition, the financial consequences are substantial. The costs of responding to an investigation or worse, an enforcement action, increase every year. The best strategy for succeeding in this environment is to be proactive.

<u>Key Takeaways</u>

- Breaches of any duty by hedge fund or private equity professionals is now likely to

be prosecuted by the SEC.

- As soon as a potential breach or other issue arises, firms must be proactive in responding to any issue and documenting that response. Covering-up a problem will only diminish the firm's ability to negotiate with regulators, who continue to expect good faith and proactive efforts to resolve issues before an enforcement action is brought.
- Bring in-house or outside counsel into the process as soon as a potential issue arises in order to protect the fact-gathering process with the attorney-client privilege.
- For perceived breaches of a serious nature, consider retaining outside counsel for an independent investigation and recommendation to executive management.
- Consider appointing a compliance officer or ombudsman to address potential whistleblower complaints internally and protect whistleblower confidentiality.

Related Resources:

Cases:

- Supreme Court Cases:
  - *Meritor Sav. Bank v. Vinson*, 477 U.S. 57, 60 (1986).
- U.S. Court of Appeals:
  - *United States v. MacDonald*, 531 F.2d 196, 199-200 (4th Cir. 1976), *cert. granted*, 432 U.S. 905 (1977), *rev'd*, 435 U.S. 850 (1978).
- State Court Cases (State Supreme Court of Ohio, for example):
  - *Herrick v. Lindley*, 391 N.E.2d 729, 731 (Ohio 1979).
- Cases Available on Electronic Media Only (Please use Westlaw rather than Lexis Nexis):
  - *Int'l Snowmobile Mfrs. Ass'n v. Norton*, No. 00-CV-229-B, 2004 WL 2337372, at *3 (D. Wyo. Oct. 14, 2004).

Short Form:

- *MacDonald*, 531 F.2d at 197.

- *Id*. at 197.

Statutes:

- United States Code:
  - 11 U.S.C. § 545 (2010).

  Note: Please cite to a year the first time the statute is used

Journals:

- David Rudovsky, *Police Abuse: Can the Violence Be Contained?*, 27 HARV. C.R.-C.L. L. REV. 465, 500 (1992).

Books:

- CHARLES DICKENS, BLEAK HOUSE 49-55 (Norman Page ed., Penguin Books 1971) (1853).

Internet Resources:

- Online Journal/Article (Article Also Available in Print – Rule 18.1):
  - J.T. Westermeier, *Ethical Issues for Lawyers on the Internet and World Wide Web*, 6 RICH. L.J. & TECH. 5, ¶ 7 (1999), *available at* http://law.richmond.edu/jolt/v6i1/westermeier.html.

- Electronic Article (Not Available in Print)

  - Article With Date Posted (Use Date Article Was Posted):
    - Amy Benfer, *Cyber slammed*, SALON (Apr. 10, 2011), http://www.salon.com/life/feature/2001/07/03/cyber_bullies/print.html.

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    - Amy Benfer, *Cyber slammed*, SALON, http://www.salon.com/life/feature/2001/07/03/cyber_bullies/print.html (last visited Apr. 30, 2011).

- Website:
  - Dunkin' Donuts, http://www.dunkindonuts.com (last visited Dec. 18, 2003).