IA Watch
WEEKLY BRIEFING
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■ INSIDE...

May 4, 2015

Hedge fund adviser charged with improperly allocating expenses

The hint came at **IA Watch**'s spring compliance conference: on the horizon the industry could expect a number of conflicts cases to be recommended for enforcement action, including issues tied to related-party transactions and fee and expense misallocations in the private fund context. That message sent by the Co-Chief of the **SEC**'s Asset Management Unit **Julie Riewe** (IA Watch, March 3, 2015) was spot on.

The SEC April 29 charged a hedge fund adviser and two of its executives for improperly allocating fund assets over a period of four years to pay undisclosed operating expenses. Santa Barbara, Calif.-based **Alpha Titans**, its principal **Timothy McCormack** and general counsel **Kelly Kaeser** were charged with using the assets of two affiliated private funds to pay more than $450,000 in office rent, employee salaries and benefits, parking, utilities, computer equipment and other expenses.

The SEC determined the payments were not clearly authorized under the funds' operating documents. The parties were also cited for not providing accurate and complete disclosures that the fund assets were being used for such purposes. "Private fund managers must be fully transparent about the type of and magnitude of expenses they allocate to the funds," said **Marshall Sprung**, co-chief of the SEC Enforcement Division's Asset Management Unit. The SEC further found that financial statements inadequately and incorrectly described the total amount of Alpha Titans' expenses paid by the funds and the related-party relationships. Outside auditor

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Cybersecurity best practices suggested in new SEC release

A new guidance update from the **SEC** released April 28 encourages steps investment and fund advisers can take to improve their ability to repel cyber threats.

The IM guidance suggests "a number of measures" advisers "may wish to consider." The measures fall into three buckets:

1. **Conduct periodic assessments** of your firm's risk of cyber attack as well as its security controls and vulnerabilities.

2. **Come up with a strategy** to "prevent, detect and respond" to threats. These could include the use of authentication codes to enter your network, the establishment of firewalls, the segregation of your network and the backing up of firm data and the testing of its retrieval.

3. **Devise written cyber and compliance P&Ps**

(Cybersecurity Advice, continued on page 2)

Options exist for private funds to obtain consent to principal trades

A clear violation occurs if an adviser were to engage in a principal trade without obtaining the consent of the client. Advisers Act section 206 offers no ambiguity:

> *It shall be unlawful ... acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction.*

But what's a private fund adviser to do when the client is the fund itself? The consent could come from the general partner of the limited partnership but often the GP is conflicted because it's also the adviser.

The most conservative approach in this situation is to get approval from each fund investor, points out **Steven Felsenthal**, general counsel/CCO at **Millburn**

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Cybersecurity Advice (Continued from page 1)

and hold staff training. The update states you may wish to educate investors as well as assess your vendors' cybersecurity protections.

Also last week, the **Department of Justice** put out best practices for victims of cyber-attacks. The 15-page document includes tips, such as to identify your "crown jewels," your key intellectual property, and offers steps to protect them from cyber bad guys.

No formal SEC rule but ...

There is no SEC rule directed at cybersecurity and IM officials have indicated it would be difficult to come up with one that could fit the entire industry. However, the SEC guidance insinuates that existing federal laws cover your duty to protect against cyber threats. Funds and advisers "should identify their respective compliance obligations under the federal securities laws and take into account these obligations when assessing their ability to prevent, detect and respond to cyber attacks," reads the guidance update.

The suggested measures aren't "intended to be comprehensive," states the SEC. They grew out of OCIE's cyber sweep (**IA Watch**, April 21, 2014), as well as IM's discussions with the industry and its "monitoring efforts."

Editor's Note: The new guidance will be discussed at **IA Watch**'s May 21st *Cybersecurity for Financial Services* conference in Washington, D.C. ■

Much of this story first appeared as breaking news at www.iawatch.com on April 28. ■

Contract sheds light on OCIE's use of tool to verify assets during exams

Last year, we told you that OCIE had contracted with a Tennessee company, **Capital Confirmation**, to do electronic verification of accounts for custody inquiries during examinations (**IA Watch**, July 28, 2014).

IA Watch has obtained via the FOIA a copy of the SEC's contract and other documents tied to the deal, which runs until 2019 and permits examiners and firms to use the company's verification tool, https://www.confirmation.com/.

Reimbursement under the contract can't exceed $5 million. The costs will be assessed based on usage. For example, an in-network standard bank confirmation for a single account would cost $23 but a discounted price of $115 would be assessed if 20 accounts were queried. OCIE would get a refund if after 20 days the information wasn't retrieved. ■

SEC's first-ever retaliation case yields payment for hedge fund whistleblower

The **SEC**'s first-ever anti-retaliation whistleblower case has now yielded a "maximum" award payment of $600,000 for the head trader at a hedge fund adviser that brought wrongdoing allegations to the Commission. The whistleblower was granted the payment for providing key original information that led to a successful June 2014 SEC enforcement action against **Paradigm Capital Management** ($937M in AUM) (**IA Watch**, June 23, 2014).

New York-based Paradigm and its principal **Candace King Weir** settled charges of violating rules for principal trades and retaliating against a Dodd-Frank whistleblower and paid a $2 million penalty. "The Enforcement Division is committed to taking action when appropriate against companies and individuals that retaliate against whistleblowers," said **Andrew Ceresney**, Director of the SEC's Division of Enforcement.

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3. Recent SEC document request letter
4. Conflicts inventory worksheet
5. Performance review form ■

Retaliation to Reward (Continued from page 2)

The SEC noted April 29 that the whistleblower had suffered "unique hardships" and stated that it recognized he had made sacrifices to ultimately play "an important role" in the enforcement action. The whistleblower secretly advised the SEC of his concerns of potential firm misconduct in March 2012 and later informed Paradigm he had done so in July 2012.

It was immediately after providing his firm with notice that he had gone to the Commission that a series of retaliatory actions kicked in against the whistleblower. The SEC found that the whistleblower was removed from his then-current position and provided with a new job function, tasked with investigating the conduct he had already detailed to the SEC, and stripped of his supervisory responsibilities. The whistleblower ultimately resigned in August 2012—only one month after revealing to his firm the SEC discussions.

'Encouraging development'

It has been a long ride for this whistleblower. **David Marshall**, a partner with the Washington, D.C.-based **Katz Marshall & Banks**, which represents whistleblowers, notes that the SEC's whistleblower program is not set up to force companies to pay back pay and other damages to whistleblowers when the companies are found to have engaged in retaliation. Katz sees the award as a "very encouraging development" with the Commission making it clear it will take into account the amount of harm done to a whistleblower when deciding how much to award for information leading to a successful enforcement action.

The SEC similarly hopes the payment leads to other potential whistleblowers coming forward. **Sean McKessy**, chief of the Commission's Office of the Whistleblower, touted the SEC's "demonstrated commitment" to protecting whistleblower's against retaliation and its ability to make "significant financial awards to whistleblowers who suffer employment hardships as a result of reporting possible securities law violations."

To date, in its more than three-year history, the SEC's Office of the Whistleblower has awarded 17 payouts to whistleblowers totaling over $50 million. ■

New SEC proposal would define non-U.S. swap activity counting toward registration

In an action that accepts the reality of the international derivatives market, **SEC** Commissioners April 29 unanimously approved a new proposal relating to when a non-U.S. person or firm would have to register under the Commission's security-based swaps regime.

"The Commission has struggled with this question for nearly two years," said Commissioner **Michael Piwowar**. It punted the issue in its major swaps final rule last year (**IA Watch**, June 30, 2014 and **IA Watch**, July 14, 2014). The proposed rule would attempt to draw the line on swaps activities by a non-U.S. entity that would have to count toward the various thresholds that would trigger the need to register with the SEC as a swaps dealer under Regulation SBSR.

If the non-U.S. entities use their personnel who are located in a U.S. branch office in connection with dealing activity – arranging, negotiating or executing the swaps transaction – then Dodd-Frank swaps rules would apply. However, if the non-U.S. entity relied upon individuals within the U.S. who aren't connected with them, the transaction wouldn't count toward the registration thresholds.

Working with the CFTC

One motivation for the proposal was a staff advisory released last year by the **CFTC** that took a similar stance on swaps activities. Dodd-Frank handed the SEC oversight of security-based swaps and the CFTC assumed responsibility for commodity and other swaps.

"Under the proposal, for example, a transaction would count in the calculations made by non-U.S. persons to determine whether they need to register with the Commission as dealers, thus ensuring their dealing activity in the United States at levels above the threshold would be subject to appropriate oversight and provide the Commission access to their books and records. These measures are particularly important because some of the most significant non-U.S. dealers are in fact part of U.S.-based financial groups," said SEC Chair **Mary Jo White**.

Piwowar noted common derivatives activities involve the interaction of U.S. and non-U.S. parties.

Commissioner **Kara Stein** supported the proposal but raised the troublesome Abacus and the London Whale derivatives cases in cautioning against an international

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SEC Swap Proposal (Continued from page 3)

regulators' "race to the bottom in swaps" regulations.

Commissioner **Luis Aguilar** noted that about 88% of global security-based swaps transactions involved non-U.S. counterparties. He said the proposal, if finalized, would "prevent restructuring charades to avoid" Dodd-Frank's regulatory regime "by plugging the loopholes allowing registered SBS dealers to book transactions overseas but otherwise handle the transactions in the U.S." ■

Compliance Options (Continued from page 1)

Ridgefield Corporation ($542M in AUM) in Greenwich, Conn. But that's only practical depending on how many investors the fund holds.

You could opt for the consent to come from a majority or a super majority of the investors, notes **Robert Leonard**, a partner with **Proskauer** in New York. You could even use a negative consent approach if you've disclosed this in your fund documents, he adds.

Even more options are available

Private fund advisers have other options, too. Off shore hedge fund advisers usually have their board of directors serve as the consenting party, says **Kelli Moll**, a partner with **Akin Gump** in New York. She says domestic fund advisers that are the general partner of the hedge fund often appoint an independent committee consisting of non-investors to serve that role, while private equity fund advisers usually create an advisory board to approve principal transactions.

"It's key to have the mechanism in place" should a principal trade come up, Moll adds.

"Those with foresight put it in their partnership agreement," says Felsenthal. He outlines two more options: an advisory group of limited partners or investors or investors through the partnership agreement "appoint" an individual or group without ties to the adviser to be the committee that will rule on principal transactions.

Yet another avenue is to appoint "an independent fiduciary," says **Monica Parry**, of counsel at **Morgan Lewis** in Washington, D.C. "They don't take on fiduciary liability for the fund," she noted.

"Your only issue is finding someone" to serve in that capacity, she adds. It would have to be a person without a business relationship with the fund or the manager so as to avoid that obvious conflict. It could be a retired lawyer or accountant. Their role would be limited to reviewing and approving principal trades. They could be paid per-use or placed on a retainer, depending on the fund's volume of principal trades.

A blanket prohibition on principal transactions

Many fund advisers prohibit principal trades – in which the adviser is a principal in the transaction – due to the obvious conflict and the Advisers Act section 206 requirements. A fund of funds adviser in Florida takes that stance. The CCO regards the idea of a committee of investors to approve the transactions as "too conflicted." If the fund happened to take part in such a trade, it would obtain the consent of every investor.

It also would launch "pretty deep" due diligence of any subadviser that sought a principal transaction, including confirming that the adviser had obtained the necessary consents.

Treat an inadvertent trade as an error

A CCO at a New York hedge fund says his employer also disallows principal transactions. However, when its trading system spots one that a portfolio manager executed without thinking, the firm's error policy would be triggered, removing the deal from the fund, placing it in an error account and charging the cost to the fund's management.

Contrast principal transactions with cross trades, meaning buying and selling the same security among client accounts managed by the same adviser. Cross trades also require consent but it need only be a one-time consent; principal transactions must be consented to on each occasion.

An adviser that owns 25% or more of a private fund would automatically define every transaction in the fund to be a principal transaction, notes Moll.

Take extra precautions in the process of getting principal trades approved when the security in question is illiquid. Have even more robust procedures in place for these trades, recommends Moll. The Florida CCO agrees. "You have to be extremely careful" about your valuation process in these cases, states the CCO. He suggests firms use an independent third party to determine the valuation of illiquid securities.

Enforcement cases

There have been two recent SEC enforcement actions in this space worth your consideration. The **Paradigm Capital Management** case (**IA Watch**, June 23, 2014; see story on page 2) used a committee structure to approve principal transactions. However, the SEC asserted that it was conflicted because the committee consisted of only the adviser's CFO and CCO.

(Compliance Options, continued on page 5)

Compliance Options (Continued from page 4)

In **Clean Energy Capital** (**IA Watch**, March 3, 2014), the adviser allegedly took secret loans from the funds – regarded as principal transactions – without disclosing them or obtaining client consent. It's unlikely one or two principal transactions without disclosure or consent would draw the SEC's ire but repeated instances certainly invite trouble.

Disclosure of your method for approving principal transactions is a given. Whoever the consent falls to should be apprised of the planned trade, given any relevant materials and should know how fair valuation was determined so they can reach an educated opinion prior to giving consent, says Parry.

Felsenthal says the consent request could be sent by e-mail and include a form for documenting their consent – a completed record the adviser would keep. You could even alert the investors that if they don't provide their consent by a certain date they will be dismissed from the fund. Document the approval of the transaction.

There are exceptions to the Advisers Act principal trading rule but they're reserved for certain scenarios involving broker-dealers (directed trades, providing impersonal advice and ones that fall under Advisers Act temporary rule 206(3)-3T). ■

Tips to avoid trouble when FINRA makes a request for your records

You don't want to mess with **FINRA** when it comes to rule 8210 (provision of information and testimony and inspection and copying of books) requests for information and documents. Yet such requests can be oppressive. E-mail requests alone can present huge and costly challenges.

First, know that rule 8210 is FINRA's most basic investigative tool. Respond appropriately – unless you plan on exiting the industry. This year alone rule 8210 violations have factored into more than 50 disciplinary actions by the SRO, an **IA Watch** review shows. In its 2015 exam priorities letter, FINRA cites a growing number of cases where firms "have repeatedly failed to provide timely responses" to rule 8210 requests and warns that "production failures expose firms to disciplinary action."

A recent $2.5 million fine slapped on **Oppenheimer & Co.** partly reflected the firm's mishandling of six separate rule 8210 requests concerning an investigation into a former broker who stole money from customers.

Douglas Troszak blew off three consecutive requests for documents from the SRO in a dispute over outside business activities. Last year, a FINRA National Adjudicatory Council decision upheld a hearing panel decision barring Troszak and expelling **North Woodward Financial Corp.**, his Birmingham, Mich., firm.

Negotiate deadlines

FINRA says it's flexible with respect to due dates, scope and format in response to its requests. **Steven Malina**, a partner with **Greenberg Traurig** in Chicago, says he has been able to negotiate relief from unusually burdensome requests. "I will often say, 'Can I get you the responses to 1, 2 and 3? You take a look, and if you still need us to pull 6, 7 and 8, we will do that,'" he says.

Once the SRO examines the first batch of documents, he says, regulators will sometimes recognize the recipient of the request doesn't have pertinent information and will back off. Malina says this is not uncommon in sweeps where investigators used standard one-size-fits-all requests.

What if you are unable to fully comply and the agency is unwilling to compromise? Respond as best you can and indicate in writing that despite best efforts you have been unable to locate all documents asked for but that you will continue to search for them.

"Put them in a position of deciding whether they really want to take steps to bring an enforcement action for failure to comply with rule 8210 if you are showing you have taken reasonable steps to comply and are cooperating," Malina says. **TIP**: Always memorialize the agreements in writing so there is no misunderstanding later.

Corporate governance options

Alan Wolper, a partner with **Ulmer & Berne** in Chicago, suggests some corporate governance measures that have been effective in narrowing agency access to certain documents:

√ **Get the owner of the B-D off of Schedule A** by creating a holding company to interpose between owner and B-D. "Those owners often have their fingers in lots of pies," Wolper says. "If I am that owner I sure do not want to open those books to FINRA. It should be irrelevant to FINRA where the rest of my money comes from."

√ **Eliminate the "control"** that a B-D executive might have over affiliated businesses' documents and information. ■

Click here to read this entire story. ■

Playing with Numbers (Continued from page 5)

Simon Lesser was aware how fund assets were used but still approved audit reports opining that the funds' financial statements were presented fairly, the settlement notes. Lesser also was charged by the SEC for his role in the misleading financial statements.

Compliance violations aplenty

The settlement reveals a laundry list of compliance failures and violations. Disclosure was an issue. Alpha Titans' Form ADV Parts 1 and 2 for 2009 through 2012 did not disclose that its clients paid most of Alpha Titans' operating expenses, which constituted compensation to the adviser.

Alpha Titans' compliance manual also had its shortcomings. The manual did not contain policies and procedures to address McCormack's control of related parties, and how that control might affect related-party transactions and required disclosures, the SEC notes. The manual further lacked provisions aimed at preventing Advisers Act violations arising from failures to disclose material conflicts of interest or to act in the best interests of clients in connection with related-party transactions, the Commission added.

McCormack—the 95% owner of Alpha Titans, who also served as CEO, managing member, chief investment officer and chief compliance officer—along with Kaeser were ultimately responsible for preparing, reviewing and updating the firm's written compliance P&Ps.

Lesser's responsibilities included considering the adequacy of related-party disclosures in the funds' financial statements but he failed in that respect. By distributing financial statements that were not GAAP-compliant, Alpha Titans' also was found to be in violation of the SEC's custody rule (rule 206(4)-2).

Paying the price

Alpha Titans' and McCormack agreed to pay nearly $700,000. McCormack and Kaeser have also been barred by the securities industry for one year and Kaeser cannot practice as an attorney on behalf of any entity regulated by the SEC for one year. Lesser will pay a $75,000 penalty and cannot practice as an accountant for an SEC-regulated entity for at least three years. ■

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