

Brief

Hedge Funds: A Look Toward 2016



On December 2, 2015, BakerHostetler's Hedge Fund Industry Practice hosted a program called "Hedge Funds: A Look Toward 2016" at the New York Yacht Club that was attended by over 60 industry participants. The program provided practical advice to hedge funds and investment advisers for the coming year through the following presentations:

- **Mark A. Kornfeld**, a partner in BakerHostetler's Hedge Fund Industry and Securities Litigation and Regulatory Enforcement Practices, presented on "Hedge Fund Hot Topics for 2016";
- **Marc D. Powers**, the National Leader of BakerHostetler's Hedge Fund Industry and Securities Litigation and Regulatory Enforcement Practices, presented "How to Effectively Manage an SEC Examination"; and
- **Lauren J. Resnick**, a partner in BakerHostetler's White Collar and Corporate Investigations Practice, and Gary Swiman, a partner in EisnerAmper's Compliance and Regulatory Services Group, presented "FinCEN's Proposed Rules on Anti-Money Laundering Policies for Investment Advisers."

Hedge Fund Hot Topics for 2016

Mr. Kornfeld emphasized that the hot topics for hedge funds in the coming year relate to "compliance, compliance, and more compliance." He explained that, due to the present-day regulatory climate, a strong compliance culture is no longer optional and "outsourcing compliance is caveat emptor." Given the government's aggressive enforcement approach, Mr. Kornfeld cautioned the audience that the "bronze standard" is no longer the expectation for compliance programs, pointing to regulatory pronouncements and several recent cases in which hedge funds were subject to enforcement actions for compliance failures.

"Strong compliance is fundamental to the fiduciary duties of the people who live and breathe in this industry. It is also viewed now as good business. It is a bad business approach to be lax in compliance. The culture at the top is no longer rhetoric. It is actually the industry standard that is expected and demanded from the regulators."

– Mark A. Kornfeld

Mr. Kornfeld stated that SEC Chair Mary Jo White recently focused on two types of risks with respect to hedge funds – firm risks and systemic risks. Mr. Kornfeld anticipated that standard marketing disclosures will continue to be a focus in 2016 as the SEC continues to make sure that hedge funds do what they say they will do. With respect to systemic risks, Mr. Kornfeld noted the SEC is focused on stress-testing hedge funds and ensuring that hedge funds have procedures for the orderly transition of client accounts or return of capital when funds are wound down. Mr. Powers agreed that it has been very apparent since the passage of Dodd-Frank that the SEC is concerned with the liquidity of hedge funds.

Mr. Kornfeld pointed out that the most significant systemic risk is cybersecurity because it "is viewed by the SEC as a universal risk that goes well beyond what you do just for your fund but impacts the market as a whole." He stated that recent SEC cybersecurity

guidance represents "a significant sea change in the perspective of the SEC about cybersecurity," noting that firms now have an affirmative obligation to build in robust cyber plans that are state of the art. Mr. Kornfeld also discussed the Office of Compliance Inspections and Examinations' (OCIE's) recent cybersecurity risk alert, which listed many cybersecurity factors on which firms should focus.

Mr. Kornfeld anticipates that the SEC will continue to pursue cases against individuals, because recent enforcement actions appear to "start with the person and work their way back to the fund." In light of this focus, he warned the C-suite that they are "not only in harm's way theoretically as agents, but [also] as individual folks charged as fiduciaries." In the context of compliance officer liability, Mr. Kornfeld noted that the SEC has recently attempted to clarify the facts and circumstances in which cases are brought against CCOs. He noted that these clarifications appear to indicate that the SEC will likely not bring cases against CCOs and other compliance personnel if they exercise fiduciary judgment in devising policies and procedures, conducting training, and promoting a culture in which people are responding to compliance gaps.

"Part of [the SEC's] message was really directed at CEOs and boards of directors. They have to give compliance personnel the resources, the support, the imprimatur of the fund that compliance is first and foremost a priority for the organization."

– Mark A. Kornfeld

Mr. Kornfeld concluded by stating that one of the enforcement tools that the SEC will continue to use in 2016 is its whistleblower program. He noted that the SEC views this program as a "huge success" and has paid out over \$54 million in whistleblower awards over the past several years. In light of the SEC's expansion of this program, Mr. Kornfeld recommended that hedge funds create an internal culture of incentivized compliance and internal reporting, and he pointed to a recent whistleblower award paid to a compliance officer because the company did not respond to warnings by the officer of imminent substantial harm to investors.

Effectively Managing SEC Examinations

Mr. Powers noted OCIE has been increasingly active in examining advisers, which he had anticipated years before when Dodd-Frank was passed and many advisers were finally required to register with the SEC. He noted that examinations by and large are risk-based, meaning OCIE is guided by the complexity of the fund and its products, the disciplinary history of the adviser, the AUM (assets under management) of the adviser, the number and type of the advisory clients, and the timeliness of the SEC filings.

Mr. Powers explained that examinations typically begin with a call by OCIE staff, during which they attempt to understand your business and compliance program so they can craft information requests and prepare for their on-site examination. He stated that OCIE staff normally contact the adviser's auditor to get an independent assessment of the nature of the adviser's business and compliance program. Because these initial steps can move quickly, he emphasized the importance of preparation.

"Another important thing that I have found during the course of these [examinations] is that you need to know the various roles, duties, and responsibilities of all the managers, supervisors, principals, marketing people, and other personnel."
— Marc D. Powers

In particular, Mr. Powers recommended that funds understand the regulatory priorities to anticipate the focus of an examination and verify the consistency among their written compliance program and their actual regulatory filings, compliance procedures, and disclosures to clients. He also cautioned that advisers should be careful with their representations to OCIE staff during the course of examinations, because careless statements will cause an adviser to lose credibility, and false statements may even subject them to criminal liability.

"Come the end of the day, you see more and more cases going from OCIE exams to enforcement." — Marc D. Powers

Mr. Powers urged the audience to consult outside counsel before, during, and after the examination and to determine how counsel may best be used to assist with it. He noted that counsel invariably can help with interfacing with OCIE staff, preparing employees for interviews, collecting and producing documents while still retaining their confidential status, and assisting in responding to the staff requests.

Mr. Powers stated that the hot buttons in recent examinations he managed were mitigation and disclosure of conflicts of interest, identification and monitoring of access persons, use of nonpublic information, and valuation of illiquid securities and private funds. He noted that OCIE staff have used former industry experts to interpret these issues more and more on recent examinations.

New FinCEN Rules on Anti-Money Laundering Policies for Investment Advisers

Ms. Resnick introduced FinCEN's proposed rules to extend the Bank Secrecy Act anti-money laundering law (AML) and suspicious activity reporting regime to investment advisers. Ms. Resnick stated that FinCEN proposed the rules in part to address its concern that individuals would use advisers to launder illicit proceeds and terrorist funds. Ms. Resnick noted that AML enforcement has been an intense area of focus of the U.S. government for some time, as well as a tool of international politics and relations. The stakes have only gotten higher as enforcement actions and the amount of penalties levied against financial institutions and broker-dealers have been increasing.

"[FinCEN's rule is] in the comment period, but it's coming. It's just a question around the edges of how it gets adjusted in terms of its expectations and application."
— Lauren J. Resnick

Ms. Resnick urged hedge funds to consider their AML and SAR reporting programs in anticipation of new regulations. Core program requirements include establishing policies, designating an AML compliance officer who has ownership of the program, training employees, auditing and periodic monitoring of the program, and establishing risk-based monitoring and Office of Foreign Assets Control (OFAC) sanctions screening. Ms. Resnick discussed the comment letter submitted by the Managed Funds Association, which notes that the risks of money laundering are reduced for investment advisers. For example, Ms. Resnick noted that some funds have lockup periods of a year or two when investors are unable to transfer their funds, making the funds less likely to be used for laundering purposes. MFA has thus requested certain clarifications and limitations of the proposed rule, but Ms. Resnick noted that investment advisers should expect the rules to pass in some form.

Ms. Resnick noted that a key to compliance programs is head count and resources. Mr. Swiman, a partner with EisnerAmper Compliance and Regulatory Services, copresented on the panel with Ms. Resnick. Mr. Swiman stressed the importance of having a process, and the current expectation of regulators that broker-dealers will monitor transactions in real time. Ms. Resnick noted the importance of establishing programs that allow advisers to understand who their direct interface customers are, and discussed the multiple challenges that exist in this area when the adviser does not have that direct interface. Ms. Resnick also highlighted the challenges of establishing a program like this, which may be inconsistent with the hedge fund environment, as investors seek these vehicles because they want confidentiality and privacy.

Ms. Resnick pointed out that the proposed rules permit hedge funds to delegate AML and suspicious activity reporting obligations. By outsourcing compliance, hedge funds can leverage off of banks' and broker-dealers' established AML programs and manage the costs inherent in establishing and

maintaining AML programs. Ms. Resnick noted that the Managed Funds Association has asked FinCEN for clarification on delegation and whether investment advisers can delegate their responsibilities to fund administrators and offshore administrators.

“Many of the hedge funds that are now registered will find it cost-prohibitive to have enough staff internally to manage these issues, so outsourcing and delegation is something that many firms do and are considering, and it needs to be done carefully.”

– Lauren J. Resnick

Ms. Resnick noted that the proposed rules require the hedge funds to take reasonable steps to confirm that the third party meets their AML compliance responsibilities. This requires them to monitor, oversee, and audit the third party. The risk, Ms. Resnick noted, is that everyone who is involved in the process could get tagged. Ms. Resnick stated that delegation is an important consideration for hedge funds looking to manage costs.

Mr. Swiman spoke about what investment advisers should be doing in anticipation of the proposed rules, which he noted are very likely to pass. He urged hedge funds to be proactive by analyzing their current programs and looking at regulators’ processes and guidance. Mr. Swiman also advised hedge funds to implement best practices prior to the passage of the final rules and to consider their options in determining the most cost-effective way to meet the requirements. Mr. Swiman advised investment advisers to be cognizant of the reality that AML requirements and regulatory inquiries are global, extending to the Cayman Islands and the Bermuda Monetary Authority.

“Start to look at your customers. Start to see even what you have for customer identification. Start to ask: How would I monitor what’s out there? What are broker-dealers doing? What are banks doing?”

– Gary Swiman

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