Emerging Issues in Hedge Fund Compliance and Professional Ethics

I. The New Law on Whistleblowers

A. The Dodd-Frank Wall Street Reform and Consumer Protections Act created a whistleblower regime applicable to hedge fund managers.

1. Section 922 of Dodd-Frank:

(a) Provides for monetary awards for people who report securities laws violations; and

(b) Creates a cause of action against employers that retaliate against whistleblowers.

(i) Includes direct and indirect discharge, demotion, suspension, threats and harassment

(ii) Covers situations where whistleblower is providing information to the SEC and also situations where whistleblower is assisting investigations or actions

2. SEC Rule 21F-17 provides that "no person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation."

B. The SEC has charged a hedge fund manager under the retaliation provision and given a monetary award to a hedge fund whistleblower.

1. *Paradigm Capital Mgmt., Inc.,* Sec. Exch. Act Rel. No. 72393 (June 16, 2014). Hedge fund manager charged with violation of the retaliation provision where the firm:

(a) Took the whistleblower out of prior position;

(b) Had the whistleblower work on a review of facts related to the allegations made; and

(c) Took away the whistleblower's supervisory responsibilities.

2. On April 28, 2015, the SEC announced it had awarded the whistleblower the maximum 30 percent recovery in connection with this matter.

(a) "We appreciate and recognize the sacrifice this whistleblower made and the important role the whistleblower played in the success of the SEC's first anti-retaliation enforcement action," said Andrew Ceresney, Director of the SEC's Division of Enforcement. "The Enforcement Division is committed to taking action when appropriate against companies and individuals that retaliate against whistleblowers."

(b) Sean McKessy, Chief of the SEC's Office of the Whistleblower, added, "Retaliation against whistleblowers is entirely unacceptable. The underlying action against Paradigm and the award to the whistleblower demonstrates the Commission's continued support of its whistleblower program." Mr. McKessy continued, "My hope is that the award today encourages potential whistleblowers to come forward in light of our demonstrated commitment to protect them against retaliatory conduct and make significant financial awards to whistleblowers who suffer employment hardships as a result of reporting possible securities law violations."

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C. The SEC has charged an employer for requiring employees to provide notification before contacting the SEC.

1. *In re KBR, Inc.*, Sec. Exch. Act Rel. No. 74619 (April 1, 2015). The SEC charged KBR with violating Rule 21F-17 by requiring employees to sign a confidentiality agreement requiring notification prior to the employee communicating with the SEC. The SEC cited the potential "chilling effect" such provisions could have on employees reporting securities violations to the SEC. Although there was no indication that any violation had occurred, or that any employee had actually been discouraged from reporting anything, the firm paid $130,000 and agreed to amend its confidentiality agreements.

2. The head of the SEC's Office of the Whistleblower advised that "[o]ther employers should similarly review and amend existing and historical agreements that in word or effect stop their employees from reporting potential violations to the SEC."

D. Ethical Issues Raised by Whistleblower Situations

1. Who Is the Client?

2. Entity Theory: A Lawyer Represents *the Organization*

(a) General Rule

(i) A lawyer employed or retained by an organization *represents the organization* acting through its duly authorized constituents.[1]

A lawyer representing only an organization does not owe duties of care, diligence or confidentiality to constituents of the organization.[2]

(ii) A lawyer *shall explain* the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.[3]

(1) By representing the organization, a lawyer does not thereby also form a client-lawyer relationship with all or any individuals employed by it or who direct its operations or who have an ownership or other beneficial interest in it, such as its shareholders.[4]

(iii) Rule 4.3 of the Model Rules of Professional Conduct reinforces a lawyer's obligation to explain the identity of the client by stating that "[w]hen the lawyer knows or reasonably should know that an unrepresented person misunderstands the lawyer's role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding."[5]

(b) Corporate Form Variations

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[1] Model Rules of Prof'l Conduct R. 1.13(a) (1983).

[2] Restatement (Third) of the Law Governing Lawyers § 96 cmt. b (2000).

[3] Model Rules of Prof'l Conduct R. 1.13(f) (1983).

[4] Restatement (Third) of the Law Governing Lawyers § 96 cmt. b (2000).

[5] Model Rules of Prof'l Conduct R. 4.3 (1983).

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(i) Closely Held Corporation

Even where a corporation only has one shareholder, a corporation exists as an entity apart from its shareholders. Therefore, in such a case, the attorney's client is the corporation and not the shareholder(s).[6]

(ii) Representation of a [General] Partnership[7]

(1) A lawyer who represents a partnership represents the "entity" and not the individual partners that constitute the partnership.

(2) As such, a lawyer undertaking to represent a partnership with respect to a particular matter does not enter into an attorney-client relationship with each member of the partnership.

(3) Therefore, information received by a lawyer during his or her representation of the partnership from individual members of the partnership may not be withheld from other members of the partnership.

(iii) Conflicts of Interest in the Corporate Family Context[8]

An affiliate of a lawyer's corporate client is not also a client for conflict of interest purposes unless:

(1) The two companies operate as alter egos;

(2) The two companies have integrated operations and management;

(3) The two companies have the same in-house legal counsel; *or*

(4) The representation of the client has provided the law firm with confidential information about the affiliate that is relevant in any matter adverse to the affiliate.

3. Reporting Bad Officer Conduct

(a) Cause for Reporting

If a lawyer knows that an officer, employee or other person associated with the organization is engaged in, or intends to engage in, something illegal that will hurt, or be imputed to, the organization and will likely result in substantial injury to the organization, then the lawyer *shall proceed* as is reasonably necessary *in the best interest of the organization*.[9]

[6] *See Fassihi v. Sommers, Schwartz, Silver, Schwartz & Tyler, P.C.*, 107 Mich. App. 509, 514 (Mich. App. 1981).

[7] ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 91-361 (1991).

[8] *See* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 95-390 (1995) (Conflicts of Interest in the Corporate Family Context).

[9] Model Rules of Prof'l Conduct R. 1.13(b) (1983).

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(b) [Internal] Reporting "Up the Ladder"

(i) "[T]he lawyer shall refer the matter … including, if warranted by the circumstances, to the highest authority that can act on behalf of the organization as determined by applicable law."[10]

(ii) If the highest authority within the corporation fails to address the violation and the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to organization, the lawyer can reveal information necessary to prevent substantial injury to the organization (even confidential information protected by the attorney-client privilege under Rule 1.6).[11]

II. Conflicts of Interest

A. The SEC has frequently raised investment adviser conflicts of interest as a key focus area.

B. The co-head of the Enforcement Division's Asset Management Unit reiterated the staff's concerns regarding conflicts in a Feb. 26, 2015 speech titled "Conflicts Conflicts Everywhere."

1. "For private funds — meaning hedge funds and private equity funds — the AMU's 2015 priorities include conflicts of interest, valuation, and compliance and controls. On the horizon, on the hedge fund side, we anticipate cases involving undisclosed fees; all types of undisclosed conflicts, including related-party transactions; and valuation issues, including use of friendly broker marks."

C. On April 20, 2015 the SEC brought an enforcement action against BlackRock Advisors LLC and its former Chief Compliance Officer in connection with a conflict of interest.

1. "According to the SEC's order instituting a settled administrative proceeding, Daniel J. Rice III was managing energy-focused funds and separately managed accounts at BlackRock when he founded Rice Energy, a family-owned and operated oil-and-natural gas company. Rice was the general partner of Rice Energy and personally invested approximately $50 million in the company. Rice Energy later formed a joint venture with a publicly-traded coal company that eventually became the largest holding (almost 10 percent) in the $1.7 billion BlackRock Energy & Resources Portfolio, the largest Rice-managed fund. The SEC's order finds that BlackRock knew and approved of Rice's investment and involvement with Rice Energy as well as the joint venture, but failed to disclose this conflict of interest to either the boards of the BlackRock registered funds or its advisory clients."

2. Without admitting or denying liability, BlackRock paid a $12-million penalty, and the former CCO paid $60,000.

III. CCO's Failure to Identify or Act on "Red Flags"

A. *Sands Bros. Asset Mgmt., LLC*, Inv. Adv. Act Rel. No. 3960 (Oct. 29, 2014) (action against hedge fund CCO who is alleged to have "substantially assisted" the manager's violations of the custody rule, where the CCO reminded colleagues of the custody rule deadlines but took no actions when they missed the deadlines, and where he was allegedly aware of prior SEC deficiency letters and consent orders regarding custody rule noncompliance but failed to implement policies and procedures to ensure compliance).

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[10] *Id.*

[11] Model Rules of Prof'l Conduct R. 1.13(c) (1983).

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B. *Parallax Investments, LLC*, Sec. Exch. Act Rel. No. 70944 (Nov. 26, 2013) (investment adviser's CCO and principal charged with willfully aiding and abetting firm's violations of its principal trading disclosure obligations, failure to comply with custody rule, failure to adopt and implement written procedures, and failure to adopt and implement written code of ethics).

C. *Ronald S. Rollins*, Sec. Exch. Act Rel. No. 70058 (July 29, 2013) (CCO of registered investment adviser charged with, inter alia, failure to supervise employee who misappropriated $16,000,000 from firm's investment advisory accounts; because of CCO's inability to pay civil monetary penalty, SEC barred him from securities industry for one year; firm required to retain independent compliance consultant, censured by SEC and settled for $120,000 penalty).

D. *Equitas Capital Advisors, LLC*, Inv. Adv. Act Rel. No. 3704 (Oct. 23, 2013) (investment adviser assessed civil penalty of $100,000 and its principal fined $35,000 after the firm, its principal and its CCO violated the securities laws by, inter alia, disseminating misleading marketing materials; failing to disclose that the firm was not directly responsible for the $1,000,000,000 that, as the firm advertised, its clients had earned since the firm's inception; failing to disclose conflicts of interest in connection with increased fees associated with certain investments; and inadvertently over- and under-billing clients).

E. *Wunderlich Sec., Inc.*, Sec. Exch. Act Rel. No. 64558 (May 27, 2011) (registered broker-dealer and investment adviser settled with SEC for violations of Advisers Act after failing to satisfy the disclosure and consent requirements for principal trades; firm settled for disgorgement of $369,366.15 and civil penalty of $125,000; firm's CCO also charged with aiding and abetting those violations by failing to tailor firm's compliance policies to those of an investment adviser after it became one (in addition to its preexisting broker-dealer business); CCO settled for $50,000, a cease-and-desist order, and a censure).

F. *Further Lane Asset Mgmt., LLC*, Sec. Exch. Act Rel. No. 70759 (Oct. 28, 2013) (investment adviser and its principal/CCO sanctioned for, inter alia, failing "to form a reasonable belief that a qualified custodian was sending account statements to fund investors at least quarterly" and to subject the firm to annual surprise examinations; firm to retain external compliance consultant, and it is censured and assessed disgorgement of $347,122; CCO is censured, suspended for 12 months and assessed a civil penalty of $150,000).

G. *Knelman Asset Mgmt. Group, LLC*, Inv. Adv. Act Rel. No. 3705 (Oct. 28, 2013) (sanctioning investment adviser and its principal/CCO for, inter alia, failing to arrange surprise examinations of assets and failing to provide fund members with audited financial statements, despite SEC notification that firm was in custody of client assets although the firm was not a qualified custodian; firm to designate new CCO, and it is censured and assessed civil penalty of $60,000; CCO barred from acting as CCO and assessed civil penalty of $75,000).

IV. Trading Issues

A. Insider Trading

1. *Thomas E. Meade*, Inv. Adv. Act Rel. No. 3855 (Jun. 11, 2014)

(a) Meade, the president and CCO of Private Capital Management Inc. ("PCM Inc."), knew of a unique risk for misuse of material nonpublic information by a vice president at PCM Inc. The vice president's father served on the board of at least one public company, but despite knowing this, Meade failed to design PCM Inc.'s compliance policies and procedures in light of the risk that the vice president might trade on information he received from his father. Additionally, Meade failed to collect, review and maintain reports of the vice president's personal securities transactions as

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required under Section 204A of the Advisers Act. Furthermore, Meade failed to put the securities of the company where the vice president's father served as a board member on a restricted or watch list of securities as required by PCM Inc.'s insider trading policy and also failed to investigate suspicious trading made by the vice president in that security. Pursuant to an offer of settlement, Meade was censured, ordered to pay a civil money penalty of $100,000, and barred from associating in a compliance capacity and supervisory capacity with any broker, dealer, investment adviser, etc.

(b) *Meade* demonstrates that compliance personnel can be held individually liable for significant fines and can receive bars when the SEC believes they have failed to do certain aspects of their jobs properly, and that these personal penalties are imposed even if the compliance officer did not personally engage in any misconduct or personally profit from another's misconduct. This case also demonstrates that the risks compliance officers must protect against are not limited to those relating to information their firms' employees obtain in the course of business; they also include information the compliance officer has reason to know an employee might learn in his or her personal capacity, such as from a family member. In *Meade*, the CCO happened to have known that the vice president's father was on the board of a particular public company, but the case sets a precedent that could allow the SEC to argue in future cases that compliance officers must determine whether their employees have relatives who are insiders at public companies and put those companies' securities on their watch list if they do.

2. *United States v. Newman*, 2014 WL 6911278 (2d Cir. Dec. 10, 2014)

(a) *Newman* reverses the conviction of two portfolio managers for insider trading. The court found, first, that the government failed to provide evidence that the alleged insiders received any personal benefit sufficient to establish tipper liability, and without tipper liability no tippee liability can arise; and second, that the government failed to present evidence showing that the portfolio managers knew that they were trading on information obtained from insiders in violation of the fiduciary duties of those insiders. The Second Circuit held that tipper liability requires a personal benefit of some consequence be received in exchange for confidential information. The court furthermore held that knowledge of a breach of the fiduciary duties of an insider cannot be inferred from the disclosure of confidential information alone, even when the information in question is detailed and accurate.

(b) While *Newman* makes it more difficult for the government to prove tippee liability, legal and compliance personnel should understand — and make sure their portfolio managers understand — that it is not a get-out-of-jail-free card. Policies and procedures designed to prevent insider trading are still needed just as they were before, and *Newman* makes clear that conscious avoidance of the source of a disclosure will not allow one to avoid liability.

B. Conflicts of Interest

1. *Alan Gavornik*, Sec. Exch. Act Rel. No. 73678 (Nov. 24, 2014)

(a) Concord Equity Group Advisors, LLC ("Concord"), through its principals Gavornik (the firm's CCO), Mariniello (the firm's president) and Argush (the firm's CEO, CFO and CTO), entered an arrangement where an unaffiliated broker-dealer would provide execution for Concord's clients at a commission rate of $0.01 per share but would charge those clients between $0.04 and $0.06 per share. The amount charged above the $0.01 per share commission rate was then paid to Concord's affiliated broker-dealer, Tore Services LLC ("Tore") as a "referral fee." This commission-sharing arrangement was not adequately disclosed to Concord's clients, with

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Concord's Form ADV Part II disclosures stating that Tore "may receive referral fees," which the SEC found not to be a complete and accurate disclosure. Because the arrangement resulted in a higher commission rate for clients, the respondents also failed to seek to obtain best execution for Concord's advisory clients. The SEC noted that the failure to disclose the arrangement accurately "rested principally" with Gavornik as CCO. As a result, and pursuant to an offer of settlement, Gavornik was suspended from associating with any broker, dealer, investment adviser, etc. for 12 months and was ordered to pay a $150,000 civil money penalty. Mariniello and Argush were not suspended, but they were each ordered to pay a $150,000 civil money penalty, and all three individuals were found jointly liable for disgorgement of $1,005,000, plus interest.

(b) *Gavornik* highlights the fact that the SEC often holds compliance personnel to a higher standard than business personnel, as here the agency suspended only Gavornik even though it was Mariniello who was the "principal architect" of the arrangement with the executing broker. The case also demonstrates that compliance personnel must ensure that their firms specifically and accurately disclose any situation wherein money paid by their clients ends up going to the adviser, or where the adviser receives remuneration from a third party with which it has an arrangement to provide services to the adviser's clients.

C. Procedures for Internal Matters

1. *Knight Capital Americas LLC*, Sec. Exch. Act Rel. No. 70694 (Oct. 16, 2013); *George B. Franz III*, Sec. Exch. Act Rel. No. 72058 (April 30, 2014)

(a) In *Knight Capital Americas LLC*, an error in Knight Capital Americas LLC's ("Knight's") automated routing system for equity orders resulted in Knight losing over $460,000,000. Following that incident, the SEC found that Knight had violated Exchange Act Rule 15c3-5, which requires that a broker or dealer have a system of risk management controls and supervisory procedures reasonably designed to limit the risks associated with market access. Perhaps more importantly, the SEC found that Knight did not have adequate supervisory procedures concerning incident response. Pursuant to an offer of settlement Knight was censured and ordered to pay a civil money penalty of $12,000,000.

(b) In *Franz*, George Franz was founder, owner and CCO of investment adviser Ruby Corporation. An employee of Ruby Corporation, Andrew Franz (who was also respondent George Franz's son), committed acts of fraud and theft of client funds, but even once he had been made aware of these acts, George Franz failed to implement policies and procedures to keep such actions from happening again. Furthermore, George Franz did not disclose the actions of his son and instead covered up the acts of fraud and theft. After George Franz failed to put in place policies and procedures reasonably designed to prevent the unauthorized withdrawal of advisory client funds, Andrew Franz committed additional acts of fraud and theft of client funds. As a result of these failures and his attempt to cover up the actions of his son, George Franz agreed to an Offer of Settlement, under which he was barred from associating with any broker, dealer, investment adviser, etc., and was ordered (jointly and severally with Ruby Corporation) to pay civil penalties of $650,000.

(c) *Knight* and *Franz* emphasize the need to have policies and procedures addressing how a firm and its compliance officers should respond in the event a problem arises, whether that problem is an accidental computer error or deliberate wrongdoing by an employee. It is important to look at your own organization and think of areas where problems could occur, and to

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proactively put in place safeguards and policies to follow in the event that a problem does occur.

V. Marketing and Valuation

A. The SEC has focused on marketing by hedge fund managers, bringing enforcement actions when the allegations are egregious, and sending deficiency letters when examinations reveal mis-steps (for example, the failure to abide by the Clover Capital guidance when using performance marketing).

B. In September 2014 then-Director of OCIE Andrew Bowden indicated that some hedge fund firms had been found to be "flip-flopping" in their valuation methodologies. Any time the methodologies change there may be a concern about the basis for doing so, particulary when they change frequently or there are frequent exceptions.

C. *In re F-Squared Investments, Inc.,* Inv. Adv. Act Rel. No. 3988 (Dec. 22, 2014). The SEC charged a fund manager with failing to disclose that performance track record used in marketing materials was back-tested to create hypothetical backtested performance. The SEC also found a compilation error in the adviser's calculations and that this error accounted for virtually all of the claimed outperformance of the S&P 500 Index. Indices sub-licensed by the adviser managed assets of approximately $28,500,000,000.

D. *Equitas Capital Advisors, LLC*, Inv. Adv. Act Rel. No. 3704 (Oct. 23, 2013). The SEC found the CCO of a fund manager liable, along with the principal of the manager and the firm itself, where the firm disseminated misleading marketing materials, among other violations. The CCO had identified concerns with the marketing materials to the principal but was still charged.

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