Schulte Roth&Zabel

Compliance Priorities for the SEC

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I. SEC and NFA Examinations and Enforcement Actions

A. In General: The SEC and NFA have expanded their examination programs in an effort to encompass the influx of advisers to private funds that are newly required to register pursuant to the Dodd-Frank Act. The SEC's Office of Compliance Inspections and Examinations ("OCIE") has developed new types of examinations and implemented new technologies to select advisers for examination and to aid the SEC staff in conducting examinations. OCIE has also hired personnel from the private sector and has been able to conduct more probing reviews of many private fund managers. The increasingly robust nature of SEC examinations, combined with a greater willingness by the OCIE staff to refer cases to the SEC's Division of Enforcement, has created an increased enforcement risk for private fund managers undergoing an SEC examination. Like the SEC, the NFA also expanded its examination program to handle the influx of newly registered CPOs and CTAs. While the NFA historically attempted to examine every member at least once every three years, that has proven difficult over the past few years, given the influx of new members. The NFA, however, appears to have reached appropriate staffing levels, resulting in many new members having recently gone through their first examination.

1. Risk-Based Examinations: Many recent examinations have been conducted on a "risk" basis, meaning that OCIE staff has analyzed data regarding the manager and funds, and has chosen the manager for examination based on perceived risks. With the aid of sophisticated new technologies, OCIE is able to more carefully and objectively prioritize advisers for examination. The NFA has also used new risk-based tools to determine which members should be examined on a non-routine basis. The NFA will look at factors such as customer complaints, habitually late filings and "red flags" in the periodic reports submitted to the NFA (i.e., Form CPO-PQR and pool financial statements).

2. Examinations for "Cause": Examinations for cause have continued to constitute a significant component of reviews of private fund managers. Whether such examinations are instigated by a potential whistleblower or by other tips, complaints or referrals ("TCRs"), these examinations are particularly sensitive because the examination staff may come in with an expectation of finding wrongdoing.[1]

B. Expenses

1. In General: Many recent examinations of both private equity and hedge fund managers have focused on the allocation of expenses, both between manager and funds, and between funds. Common deficiencies related to expense allocations have included: (1) over-allocating expenses to one client where another client will not pay such expenses (e.g., a managed account client won't pay for "broken-deal" expenses and the fund client therefore pays the full amount); and (2) charging expenses to the fund that are not clearly disclosed to investors (e.g., certain consultant expenses). Examination staff have been aggressively drilling down on expense allocations even where the amounts are de minimis. In addition, many examiners have requested that the manager itself conduct a thorough review of all expenses charged to clients. In anticipation of such scrutiny, many managers have conducted those reviews prior to examination and made remediation to affected funds where appropriate.

2. KKR: On June 29, 2015, the SEC initiated, and settled, cease-and-desist proceedings against Kohlberg Kravis Roberts & Co. LP ("KKR") in connection with misallocation of expenses related to unsuccessful buyout opportunities ("broken deal expenses"). This was "the first SEC case to charge

[1] Carlo V. di Florio, Director, Office of Compliance Inspections and Examinations, Speech by SEC Staff: Remarks at the Compliance Outreach Program, Washington, D.C. (Jan. 31, 2012), *available at* www.sec.gov/News/Speech/Detail/Speech/1365171489758.

a private equity adviser with misallocating broken deal expenses."[2] KKR advises and manages its "flagship" private equity funds, along with co-investment vehicles. The limited partnership agreement for KKR's largest fund, the KKR 2006 Fund LP ("2006 Fund") allowed KKR to allocate broken deal expenses "incurred by or on behalf of" the 2006 Fund. According to the SEC, however, KKR did not also allocate the broken deal expenses to the co-investment vehicles and did not disclose the disparate treatment. As a result, KKR misallocated broken deal expenses of $17.4 million to the flagship funds.

3. Blackstone: On Oct. 7, 2015, the SEC initiated, and settled, cease-and-desist proceedings against Blackstone Management Partners LLC, Blackstone Management Partners III LLC, and Blackstone Management Partners IV LLC (collectively, "Blackstone"). These proceedings arose from alleged inadequate disclosures that involved two distinct breaches of fiduciary duty.[3] First, from at least 2010 through March 2015, upon either the private sale of a portfolio company or an initial public offering ("IPO"), Blackstone terminated certain portfolio company monitoring agreements and accelerated the payment of future monitoring fees as set forth in the agreements. Although Blackstone disclosed that it may receive monitoring fees from portfolio companies held by the funds it advised, and disclosed the amount of monitoring fees that had been accelerated following the acceleration, Blackstone failed to disclose to its funds, and to the funds' limited partners prior to their commitment of capital, that it may accelerate future monitoring fees upon termination of the monitoring agreements. Second, in late 2007, Blackstone negotiated a single legal services arrangement with its primary outside law firm (the "Law Firm") on behalf of itself and the funds. For the majority of legal services performed by the Law Firm beginning in 2008 and continuing through early 2011, Blackstone received a discount that was substantially greater than the discount received by the funds. The disparate legal fee discounts were not disclosed to the funds or the funds' limited partners until August 2012. Because of its conflict of interest as the recipient of the accelerated monitoring fees and the beneficiary of the disparate legal fee discounts, Blackstone could not effectively consent to either of these practices on behalf of the funds it advised. As a result, Blackstone breached its fiduciary duty to the funds in violation of Section 206(2) of the Advisers Act and also violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

4. Cherokee: On Nov. 5, 2015, the SEC initiated, and settled, cease-and-desist proceedings against Cherokee Investment Partners LLC ("CIP") and Cherokee Advisers LLC ("CA") (collectively referred to as "Cherokee") in connection with the alleged improper allocation to client funds (the "Cherokee Funds") of certain consulting, legal and compliance-related expenses.[4] Between July 2011 and March 2015, CIP and CA incurred consulting, legal and compliance-related expenses in the course of preparing for registration as an investment adviser under the Advisers Act, complying with legal obligations arising from registration and responding to the OCIE staff and the staff of the Commission's Division of Enforcement. Cherokee allocated to the Cherokee Funds, and caused the Cherokee Funds to pay for, $455,698 of these expenses. Although the Cherokee Funds' limited partnership agreements disclosed that the Cherokee Funds would be charged for expenses that in the good faith judgment of the general partner arose out of the operation and activities of the Cherokee Funds, including the legal and consulting expenses of the Cherokee Funds, there was no disclosure that the Cherokee Funds would be charged for the advisers' legal and compliance expenses. As a result, CIP and CA allegedly breached their fiduciary duties to the Cherokee Funds in

[2] Press Release, Securities and Exchange Commission, SEC Charges KKR with Misallocating Broken Deal Expenses (June 29, 2015), *available at* www.sec.gov/news/pressrelease/2015-131.html.

[3] *In the Matter of Blackstone Management Partners L.L.C., Blackstone Management Partners III L.L.C., and Blackstone Management Partners IV L.L.C.*, Release No. IA-4219, Securities and Exchange Commission (Oct. 7, 2015).

[4] *In the Matter of Cherokee Investment Partners, LLC and Cherokee Advisers, LLC*, Release No. IA-4258, Securities and Exchange Commission (Nov. 5, 2015).

violation of Section 206(2) of the Advisers Act and also allegedly violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

5. Cranshire: On Nov. 23, 2015, the SEC initiated, and settled, cease-and-desist proceedings against Cranshire Capital Advisors, LLC ("CCA") in connection with alleged negligent allocation of compliance-related expenses to a private fund client of CCA (the "CCA Fund").[5] From 2012 through 2014, CCA employed an outside attorney to serve as a compliance consultant to advise it on registration and compliance matters. The services provided by the consultant related to the creation and operation of CCA's compliance program rather than any investments or operations of the CCA Fund. During this period, CCA improperly used $158,650 in CCA Fund assets to pay the consultant's fees in a manner that was not disclosed in the CCA Fund's organizational documents. The CCA Fund's private placement memorandum and limited partnership agreement both disclosed that CCA would "provide the [CCA Fund] with office space and utilities. The [CCA Fund] will pay all its other expenses, including … legal and accounting fees." Similarly, an Omnibus Management Agreement covering the CCA Fund (the "Management Agreement") provided that CCA would render its services to the CCA Fund "at its own expense, including, without limitation, operating expenses (such as rent for office space and telephone lines) … unless such expenses are otherwise expenses to be borne by the Funds as described above." Regarding legal and compliance expenses, the Management Agreement stated only that "each Fund shall bear its own expenses, including … external legal expenses." The SEC found that none of these provisions authorized CCA to charge the CCA Fund for its own compliance consulting fees. As a result, CCA allegedly breached its fiduciary duty to the CCA Fund in violation of Section 206(2) of the Advisers Act and also allegedly violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

C. Conflicts and Disclosures (Including Marketing)

1. In General: In the past year, many government enforcement efforts with respect to private funds have also centered on conflicts of interest, as forewarned by Julie Riewe, co-chief of the Asset Management Unit of the SEC's Division of Enforcement, in her February 2015 speech, "Conflicts, Conflicts Everywhere."[6] Riewe made the following related points in her speech:

   (a) The SEC staff are examining, at least in part, whether advisers are discharging their fiduciary obligation "to identify [their] conflicts of interest and either (1) eliminate them, or (2) mitigate them and disclose their existence to boards or investors." Advisers should ask the following questions:

      (i) For each conflict identified, as a threshold matter, can the conflict be eliminated? If not, why not?

      (ii) As to mitigation, are the firm's policies and procedures reasonably designed to address the conflicts the firm has identified, and are they properly implemented?

      (iii) As to written disclosure, has the firm reviewed, and does the firm review regularly, all of the relevant disclosure documents to ensure that all conflicts are disclosed, and disclosed in a manner that allows clients or investors to understand the conflict, its magnitude and the particular risk it presents?

[5] *In the Matter of Cranshire Capital Advisors*, LLC, Release No. IA-4277, Securities and Exchange Commission (Nov. 23, 2015).

[6] Securities and Exchange Commission, *Conflicts, Conflicts Everywhere – Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View*, Washington, D.C. (Feb. 26, 2015), *available at* www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html.

(b) The SEC staff expect to recommend a number of conflicts cases for enforcement action, including matters involving best execution failures, undisclosed outside business activities, related-party transactions, fee and expense misallocation issues, undisclosed bias toward proprietary products and investments, and conflicts presented by advisers using the fund's assets to grow the fund and, consequently, the adviser's own fee.

2. BlackRock: In April 2015 the SEC instituted a settled administrative proceeding against BlackRock Advisors LLC ("BlackRock"), alleging that BlackRock breached its fiduciary duty to its clients by failing to disclose a conflict of interest.[7] BlackRock portfolio manager Daniel J. Rice III, who managed energy-focused funds, founded Rice Energy, an oil and natural gas company, of which Rice was the general partner and in which Rice invested $50 million of his own money. Rice Energy formed a joint venture with a publicly traded coal company; that joint venture eventually became the largest holding in BlackRock's Energy & Resources Portfolio, which was managed by Rice. The SEC alleged that BlackRock knew and approved of Rice's involvement in the joint venture, but failed to disclose the conflict of interest to the boards of the registered funds or advisory clients. Blackrock was charged with certain violations of the Investment Advisers Act of 1940 (the "Advisers Act") that do not require scienter.

3. JP Morgan: On Dec. 18, 2015, the CFTC issued an order filing and settling charges against JPMorgan Chase Bank, N.A. ("JPMCB").[8] The CFTC found that JPMCB failed to disclose certain conflicts of interest to clients of its U.S.-based wealth management business, J.P. Morgan Private Bank. Specifically, JPMCB failed to fully disclose its preference for investing its client funds in certain commodity pools or exempt pools, namely hedge funds and mutual funds managed and operated by an affiliate and subsidiary of JP Morgan Chase & Co. JPMCB also failed to disclose its preference for investing its clients' funds in third-party-managed hedge funds, each a commodity pool or exempt pool, that shared management and/or performance fees with a JPMCB affiliate. Aitan Goelman, the CFTC's Director of Enforcement, commented that "Investors are entitled to know if a bank managing their money favors placing investments in its own proprietary funds or other vehicles that generate fees for the bank."

4. Guggenheim: In another matter highlighting the SEC staff's focus on conflicts of interest issues, the SEC brought charges in August 2015 against Guggenheim Partners Investment Management LLC ("Guggenheim"), an investment adviser that provides investment management services primarily to institutional clients, high-net-worth individuals and private funds.[9] The SEC alleged that a senior Guggenheim executive obtained a loan from an advisory client in July 2010. The next month, the same executive invested both that client and other clients in two transactions, but did so on different terms for the client from whom he had obtained the loan. The SEC alleged that although senior officials at Guggenheim were aware of the loan, none of them informed the company's compliance staff, nor was the loan disclosed to the other advisory clients. As noted by Andrew J. Ceresny, Director of the SEC Division of Enforcement, "As fiduciaries, investment advisors must be vigilant about disclosing all material facts to their clients, including actual and potential conflicts of interest."[10] Guggenheim was charged with certain violations of the Advisers Act that do not require scienter.

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[7] Press Release, Securities and Exchange Commission, SEC Charges BlackRock Advisors with Failing to Disclose Conflict of Interest to Clients and Fund Boards (April 20, 2015), *available at* www.sec.gov/news/pressrelease/2015-71.html.

[8] Press Release, Commodity Futures Trading Commission, CFTC Orders JPMorgan Chase Bank, N.A. to Pay $100 Million for Failure to Disclose Conflicts of Interest (Dec. 18, 2015), *available at* www.cftc.gov/PressRoom/PressReleases/pr7297-15.

[9] Press Release, Securities and Exchange Commission, Guggenheim Partners Investment Management LLC Settles Charges It Failed to Disclose Conflict to Clients (Aug. 10, 2015), *available at* www.sec.gov/news/pressrelease/2015-162.html.

[10] *Id.*

5. Reliance: In December 2014, the SEC brought a litigated administrative proceeding, in which it alleged scienter-based fraud charges against Reliance Financial Advisers ("Reliance") and its two co-owners, alleging that the firm made false and misleading statements to clients when recommending investments in a risky hedge fund. The SEC alleged that Reliance encouraged clients to invest in the Prestige Fund, a hedge fund managed by Scott Stephan. Although Stephan had virtually no hedge fund investing experience, Reliance allegedly disseminated materials claiming that the fund was an appropriate investment for retirees living on fixed incomes or for those nearing retirement. The Prestige Fund's trading strategy was described to prospective investors as being fully automatic and governed by a computer algorithm. The Prestige Fund collapsed after losing 80 percent of its value as a result of Stephan manually placing trades, contrary to the automated trading strategy marketed to investors. In a statement, Andrew Calamari, director of the SEC's New York Regional Office, argued that Reliance's co-owners violated their fundamental duty of complete candor "by peddling a hedge fund investment that was more risky than depicted and misleading their clients about the portfolio manager's experience."

6. Citigroup: In August 2015, the SEC instituted a settled administrative proceeding charging that two affiliates of Citigroup defrauded investors in two hedge funds by claiming they were safe, low-risk and suitable for traditional bond investors.[11] Although the written materials provided to investors contained truthful disclosures, the SEC alleged that Citigroup Global Markets Inc. ("CGMI") and Citigroup Alternative Investments LLC ("CAI"), both registered investment advisers, failed to disclose the high risks of investing in the funds in verbal conversations with investors, and continued to accept investments even as the funds began to collapse amid the financial crisis. As noted by Andrew Ceresney, "Firms cannot insulate themselves from liability for their employees' misrepresentations by invoking the fine print contained in written disclosures."[12] CGMI and CAI were charged with certain violations of the Securities Act of 1933 and the Advisers Act that do not require scienter.

7. Ranieri: On March 8, 2013, the SEC filed and settled charges against Ranieri Partners LLC, Donald Phillips (a former senior executive at Ranieri Partners) and William Stephens (an external marketing consultant to Ranieri Partners).[13] The SEC alleged that Stephens acted as an unregistered broker in violation of Section 15(a) of the Securities Exchange Act in marketing and receiving placement fees for the sale of interests in two real estate funds organized and advised by Ranieri Partners. The settlement orders cite a number of factors as support for this allegation, including the fact that Stephens received "transaction-based compensation totaling approximately $2.4 million." The Ranieri case has two particular points of interest for private fund managers: First, unlike many other cases brought for failure to register as a broker-dealer, there were no allegations of fraud. Second, in addition to charging the consultant for failing to register as a broker-dealer, the SEC charged the private fund manager itself and a former senior executive at the manager.

D. Insider Trading

1. Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder prohibit the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly or derivatively, to the issuer of that security or the shareholders of that issuer, or

[11] Press Release, Securities and Exchange Commission, Citigroup Affiliates to Pay $180 Million to Settle Hedge Fund Fraud Charges (Aug. 17, 2015), *available at* www.sec.gov/news/pressrelease/2015-168.html.

[12] *Id.*

[13] *In the Matter of Ranieri Partners LLC and Donald W. Phillips*, Securities Exchange Act Release No. 69091, Investment Advisers Act of 1940 Release No. 3563, Administrative Proceeding File No. 3-15234 (March 8, 2013); *In the Matter of William M. Stephens*, Securities Exchange Act Release No. 69090, Investment Company Act of 1940 Release No. 30417, Administrative Proceeding File No. 3-15233 (March 8, 2013).

to any other person who is the source of the material nonpublic information.[14] Similarly, CFTC Rule 180.1 may prohibit a person from trading commodity interests on the basis of material nonpublic information in breach of a pre-existing duty (established by another law or rule, agreement, understanding or some other source), or trading on the basis of material nonpublic information that was obtained through fraud or deception.[15] While the CFTC has to date only brought one insider trading case, it has stated that it "will be guided, but not controlled, by the substantial body of judicial precedent applying the comparable language of SEC Rule 10b-5."

2. Galleon Cases: Since 2009, the SEC has charged 35 defendants trading in the securities of 15 companies generating illicit profits of more than $96 million.[16] A total of 34 defendants have settled the SEC's charges. The alleged illegal conduct involved Raj Rajaratnam and his New York-based hedge fund Galleon Management making cash payments in exchange for material nonpublic information. The case eventually implicated corporate executives, consultants, rating agency personnel, proprietary traders, hedge fund executives and public relations personnel.

3. Newman: Recently, the U.S. Court of Appeals for the Second Circuit reversed two high-profile insider trading convictions in *U.S. v. Newman*.[17] On Dec. 10, 2014, the Second Circuit held that to sustain insider trading charges against a tippee who trades on material nonpublic information, the government must prove that the tippee knew that the tipper disclosed the information in breach of a duty of trust and confidence in order to receive a personal benefit. The court further explained that the benefit must be objective and consequential. In doing so, the court criticized the government for "the doctrinal novelty of its recent insider trading prosecutions," which the court described as "increasingly targeted at remote tippees many levels removed from corporate insiders." Additionally, *Newman* rejects the notions that mere ephemeral benefits would suffice to constitute the breach, and that the tippee need not know that a personal benefit was the quid pro quo for the improper disclosure. Accordingly, the decision is expected to present new obstacles to criminal prosecutions and SEC enforcement actions alleging insider trading violations, particularly against remote tippees. We may already be seeing the effects of the decision in the Manhattan U.S. Attorney's Office dismissing criminal charges against a dozen people besides Todd Newman and co-defendant Anthony Chiasson — 10 of whom had already pled guilty to insider trading[18] — and in an in-house judge dismissing an SEC administrative proceeding against former Wells Fargo trader Joseph Ruggieri, after finding the Enforcement Division did not prove Ruggieri's alleged tipper received a significant personal benefit for his information.[19]

4. Motazedi: On Dec. 2, 2015, the CFTC brought and settled an action against Arya Motazedi, a proprietary gasoline and energy trader at an unnamed public company in Chicago.[20] According to the CFTC, Motazedi had access to confidential, proprietary information concerning his employer's

[14] 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b–5.

[15] Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41398, 41399 (July 14, 2011).

[16] Securities and Exchange Commission, SEC Enforcement Actions: Insider Trading Cases, *available at* www.sec.gov/spotlight/insidertrading/cases.shtml.

[17] *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).

[18] Ed Beeson, "SEC Retooling Insider Trading Tactics After Newman," *Law360* (Nov. 4, 2015), *available at* www.law360.com/articles/723289/sec-retooling-insider-trading-tactics-after-newman.

[19] *In the Matter of Gregory T. Bolan, Jr., and Joseph C. Ruggieri*, Initial Decision Release No. 877, Securities and Exchange Commission (Sept. 14, 2015).

[20] *In the Matter of Arya Motazedi*, CFTC Docket No. 16-02 (Dec. 2, 2015). *See also* "The CFTC Brings (and Settles) Its First Insider-Trading Case: Implications for All Private Fund Managers," SRZ Alert (Dec. 15, 2015), *available at* www.srz.com/files/News/8ab2bc57-805e-4074-b7f6-9b16fec6c213/Presentation/NewsAttachment/86944d3b-244c-464f-82da-2195866c0973/121515_The_CFTC_Brings_and_Settles _Its_First_Insider_Trading_Case_Implications_for_All_Private_Fu.pdf.

proprietary trading in energy commodities (e.g., timing, amounts and prices) and he used that knowledge: (i) to enter "opposite side" orders that matched with his employer's orders at least 34 times (causing the employer's account to buy energy futures at higher prices and sell at lower prices, profiting Motazedi and harming his employer), at least some of which were designed as "round trip" transactions (where both sides bought and sold with the other and neither party experienced a net change in its positions); and (ii) to "front run," on at least 12 occasions, his employer's orders (allowing Motazedi to benefit from any subsequent price movement caused by the subsequent execution of the employer's oil and gas futures orders). The CFTC noted that, of the two accounts that Motazedi controlled and utilized in these activities, he only owned one of them.

5. Riley: On March 4, 2015, the U.S. District Court for the Southern District of New York refused to reverse the insider trading conviction of former Foundry Networks Inc. executive David Riley.[21] Prosecutors alleged that Riley provided his friend Matthew Teeple, a former hedge fund analyst, with Foundry's financial data and advance notice of its 2008 acquisition by Brocade Communications Systems Inc. Citing the redefined personal benefit standard in *U.S. v. Newman*, Riley has argued to the Second Circuit that his conviction should be overturned because the jury instructions did not require jurors to find that he had received a personal benefit in exchange for providing information to Teeple. Judge Caproni of the Southern District of New York had held that the instructions were not improper because maintaining a friendship could be circumstantial evidence that the tipper and tippee had a "quid pro quo relationship." The court also pointed out that Riley had received "concrete" benefits in exchange for providing the inside information, namely investment advice, assistance with a side business, and help finding a new job.[22] Riley filed his appeal on Aug. 28, 2015.[23]

6. Policies and Procedures

   Rule 206(4)-7 of the Advisers Act provides that if you are an investment adviser registered or required to be registered under the Advisers Act, you must: (i) adopt and implement written policies and procedures reasonably designed to prevent violation, by you and your supervised persons, of the applicable federal securities laws; (ii) review, no less frequently than annually, the adequacy of such policies and procedures; and (iii) designate an individual (who is a supervised person) responsible for administering your policies and procedures.[24]

7. Importance of Documentation

   (a) SEC Document Requests: When the SEC staff conducts an examination of an adviser, they request information and documents from the adviser to assess the adviser's compliance with the applicable federal securities laws, including the Advisers Act and the Company Act. Ensuring documentation of compliance policies, procedures and the implementation of such policies and procedures is, therefore, critical to preparing for an SEC examination. A document request list from the SEC staff may include, among other things:

      (i) The firm's organizational charts;

      (ii) Demographic and other data for advisory clients, including privately offered funds;

[21] Jonathan Stempel, "U.S. Judge Upholds Insider Trading Conviction Despite Law Change," *Reuters* (March 4, 2015), *available at* www.reuters.com/article/us-usa-insidertrading-riley-idUSKBN0M02BE20150304.

[22] Docket Entry No. 252, *United States v. Riley*, No. 13-CR-339-1 (VEC) (S.D.N.Y. March 3, 2015).

[23] Docket Entry No. 44, *United States v. Riley*, No. 15-1541 (2d Cir. Aug. 28, 2015).

[24] 17 CFR 275.206(4)-7.

(iii) A trade blotter, i.e., a record of all trades placed for its clients/funds (including all trade errors, cancellations, re-bills and reallocations);

(iv) Information about the firm's compliance risks;

(v) The written policies and procedures that the firm has established and implemented;

(vi) Documents relating to the firm's compliance testing (e.g., the results of any compliance reviews, quality control analyses, surveillance, and/or forensic or transactional tests performed by the firm);

(vii) Information regarding actions taken as a result of compliance testing (e.g., any warnings to or disciplinary action of employees, changes in policies or procedures, redress to affected clients, or other measures);

(viii) Any restricted, watch, or grey lists that were in effect for the examination period;

(ix) Any threatened, pending and settled litigation or arbitration involving the firm or any "supervised person"; and

(x) Any client complaints.

E. Tag Along: From Examination to Enforcement

1. In general: There is a close connection between SEC examinations and enforcement actions as highlighted by Riewe in her February 2015 speech. Riewe noted there is close coordination and collaboration between the Enforcement Division and OCIE and that the Enforcement Division has always worked many cases referred by exam staff.[25] While she said she believed that not every exam deficiency warrants an enforcement response, she acknowledged it was important that exam staff have the ability to refer matters when in their judgment the conduct warrants enforcement action. Furthermore, the 2015 Agency Financial Report by the SEC provides that in fiscal year 2015, OCIE made more than 200 referrals, many of which resulted in enforcement investigations and/or actions.[26] The NFA tends to handle many of its enforcement actions internally and generally refers only the more serious allegations to the CFTC. NFA enforcement actions are generally related to conflicts of interest issues, late filings and failing to disclose or incorrectly disclosing conflicts, past performance, expenses and other related exposures. Trading-related issues are generally handled by the futures exchanges (who could also refer such cases to the CFTC).

2. Trend: While there have long been examinations that led to enforcement investigations, there is evidence indicating that the rate of referrals to the Enforcement Division has increased. OCIE's regional offices increased the number of cases referred to enforcement from 232 in fiscal year 2006 to 272 in fiscal year 2010, with a particularly large increase between fiscal year 2008 (198 cases) and fiscal year 2010.[27] Additionally, the SEC's Office of the Inspector General published a report in June 2001 stating that approximately 5 percent of investment adviser examinations result in a referral to the Enforcement Division, which can be contrasted with OCIE Director Andrew Bowden's recent statement that approximately 10 percent of investment adviser examinations result in a referral to

[25] Riewe, *supra* note 6.

[26] Securities and Exchange Commission, Agency Financial Report, Fiscal Year 2015 (2015), *available at* www.sec.gov/about/secpar/secafr2015.pdf.

[27] Office of Inspector General, Securities and Exchange Commission, *OCIE Regional Offices' Referrals to Enforcement*, Report No. 493 (March 30, 2011), *available at* www.sec.gov/oig/reportspubs/493.pdf.

enforcement.[28] Several Enforcement Division attorneys have also moved to OCIE, including the head of the investment adviser examination program in the New York Regional Office,[29] which covers a large segment of the private funds industry.

3. Notable Cases

(a) Transamerica: Transamerica Financial Advisors Inc. ("TFA"), a registered investment adviser and broker-dealer, allegedly failed to apply advisory fee discounts to certain retail clients in several of its advisory fee programs contrary to its disclosures to clients and its policies and procedures.[30] During the relevant period, TFA offered clients in these programs breakpoint discounts that reduced the total advisory fee as the clients' assets in the programs increase. In various Form ADV Part 2 filings and in account opening documents, TFA represented that clients may request that TFA aggregate the values of certain related accounts to achieve these discounts. In addition, TFA's policies and procedures required that clients receive the savings from breakpoint discounts. Despite these disclosures, from January 2009 to June 30, 2013, TFA allegedly failed, in certain instances, to apply the breakpoint discounts despite client requests for aggregation. The Commission's examination staff first alerted TFA to certain of these problems in early 2010, but TFA failed to take adequate remedial steps. As a result, TFA allegedly improperly calculated advisory fees and thereby overcharged certain client accounts.

(b) ZPR: On April 4, 2013, the SEC initiated cease-and-desist proceedings against ZPR Investment Management Inc. ("ZPR") following an SEC examination that showed ZPR's performance marketing to be misleading because ZPR claimed compliance with the Global Investment Performance Standards when that was not the case.[31]

(c) GMB: On April 20, 2012, the SEC initiated, and settled, cease-and-desist proceedings against GMB Capital Management LLC and GMB Capital Partners LLC (collectively "GMB") following an SEC examination of GMB that showed misrepresentations regarding performance, misrepresentations regarding fund strategy, and creation of false documents during the course of the examination to try to support the performance claims.[32]

(d) F-Squared: On Dec. 22, 2014, the SEC initiated, and settled, cease-and-desist proceedings against F-Squared Investments Inc. ("F-Squared") following an SEC examination that showed back-tested returns were not properly identified as such.[33] F-Squared settled, agreeing to disgorgement and penalties of $35 million. The former CEO of F-Squared was charged with fraud under Sections 206 and 207 of the Advisers Act for his role in the misleading performance marketing.

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[28] *Compare* Office of Inspector General, Securities and Exchange Commission Audit No. 322, Compliance Inspection and Examination Referrals to Enforcement (June 28, 2001), *available at* www.sec.gov/about/oig/audit/322fin.pdf, *with* Yin Wilczek, "Only One in 10 SEC Exams Referred for Enforcement Action, Official Says," *Bloomberg BNA* (March 15, 2013).

[29] Press Release, Securities and Exchange Commission, Ken C. Joseph Named Head of Investment Adviser/Investment Company Examination Program in SEC's New York Regional Office (July 3, 2012), *available at* www.sec.gov/News/PressRelease/Detail/ PressRelease/1365171483018.

[30] *In the Matter of Transamerica Financial Advisors, Inc.*, Release No. 3808, Securities and Exchange Commission (April 3, 2014).

[31] *In the Matter of ZPR Investment Management, Inc. and Max E. Zavanelli*, Release No. IA 3574, Securities and Exchange Commission (April 4, 2013).

[32] *In the Matter of GMB Capital Management LLC, GMB Capital Partners LLC, Gabriel Bitran and Marco Bitran*, Release No. IA 3399, Securities and Exchange Commission (April 20, 2012).

[33] *In the Matter of F-Squared Investments, Inc.*, Release No. IA 3988, Securities and Exchange Commission (Dec. 22, 2014).

(e) Alpha Titans: The SEC settled administrative and cease-and-desist proceedings against a registered adviser, Alpha Titans LLC, its principal and its general counsel for non-scienter fraud, custody rule and compliance charges.[34] The OCIE examination identified that the adviser and key individuals used assets of two affiliated private funds to pay for most of the firm's operating expenses, but it did not seek clear investor authorization to do so.[35] The funds' financial statements provided to investors also were misleading because they did not disclose the use of the funds' money by entities that its principal controlled.

(f) Other notable cases include the KKR case discussed above and *In the Matter of AlphaBridge Capital Management, LLC*, [36] in which the SEC settled administrative proceedings against a registered adviser, AlphaBridge Capital Management LLC ("Alphabridge"), and its two principals for their alleged fraudulent inflation of the prices of mortgage-backed securities held by certain private funds managed by AlphaBridge.

4. Whistleblowers

(a) KBR: On April 1, 2015, the SEC initiated, and settled, cease-and-desist proceedings against Houston-based global technology and engineering firm KBR Inc. for violating whistleblower protection Rule 21F-17 enacted under the Dodd-Frank Act.[37] KBR required witnesses in certain internal investigation interviews to sign confidentiality statements with language warning that they could face discipline and even be fired if they discussed the matters with outside parties without the prior approval of KBR's legal department. Since these investigations included allegations of possible securities law violations, the SEC found that these terms violated Rule 21F-17, which prohibits companies from taking any action to impede whistleblowers from reporting possible securities violations to the SEC. Increased protection for whistleblowers may lead to increased whistleblowing and related examinations or enforcement actions.

(b) Statistics: For each year that the whistleblower program has been in operation, the SEC has received an increasing number of whistleblower tips.[38] The number of whistleblower tips increased as follows: 334 in 2011; 3,001 in 2012; 3,238 in 2013; 3,620 in 2014; and 3,923 in 2015. The Office of the Whistleblower currently is tracking over 700 matters in which a whistleblower's tip has caused a Matter Under Inquiry or investigation to be opened or has been forwarded to Enforcement staff for review and consideration in connection with an ongoing investigation.

(c) Paradigm Capital: In 2015, the SEC's Whistleblower Program awarded eight whistleblowers with total awards of approximately $38 million,[39] including the following case: On April 28, 2015, the SEC announced a maximum whistleblower award payment of 30 percent of amounts collected in connection with *In the Matter of Paradigm Capital Management, Inc. and Candace*

[34] *In the Matter of Alpha Titans, LLC*, Release No. IA 4073, Securities and Exchange Commission (April 29, 2015).

[35] Agency Financial Report, Fiscal Year 2015, *supra* note 21.

[36] Release No. IA 4135, Securities and Exchange Commission (July 1, 2015).

[37] Press Release, Securities and Exchange Commission, SEC: Companies Cannot Stifle Whistleblowers in Confidentiality Agreements (Apr. 1, 2015), *available at* www.sec.gov/news/pressrelease/2015-54.html.

[38] Securities and Exchange Commission, 2015 Annual Report to Congress on the Dodd-Frank Whistleblower Program (2015), *available at* www.sec.gov/whistleblower/reportspubs/annual-reports/owb-annual-report-2015.pdf.

[39] Press Release, Securities and Exchange Commission, SEC Announces Enforcement Results For FY 2015 (Oct. 22, 2015), *available at* www.sec.gov/news/pressrelease/2015-245.html.

King Weir, File No 3-15930 (June 16, 2014), the Commission's first anti-retaliation case.[40] The proceedings involved a whistleblower who reported certain trading activity revealing that Candace King Weir ("Weir") caused her affiliated investment adviser Paradigm Capital Management Inc. ("Paradigm") to engage in principal transactions with C.L. King & Associates Inc., an affiliated broker-dealer owned by Weir, without providing effective disclosure to, or obtaining effective consent from, PCM Partners LP II, a hedge fund client advised by Paradigm.[41] The whistleblower received over $600,000 for providing information that led to the success of the SEC action.

(d) The CFTC's whistleblower program is relatively new and was established under the Dodd-Frank Act. The program was closely modeled after the SEC's program, although the CFTC has only paid out two whistleblower awards to date: a $240,000 payout in 2014 and $290,000 in September 2015. The CFTC did not provide any details regarding the resulting enforcement actions.

[40] *See* Order Determining Award Claim, Exchange Act Rel No 74826, File No 2015-4 (April 28, 2015). The name of the case was included in the final order and accompanying press release because such information was already in the public domain in light of the earlier enforcement action in this matter

[41] *In the Matter of Paradigm Capital Management, Inc. and Candace King Weir*, Release No. IA 3857, Securities and Exchange Commission (June 16, 2014).