

Bullet Point ®

SEC Examinations of Advisers More Likely to Result in Enforcement Actions ¹

The Securities and Exchange Commission's ("SEC") enforcement initiative against investment advisers has resulted in several actions filed in the last month that are discussed below. The initiative, which the SEC calls the "Aberrational Performance Inquiry," uses risk analytics to evaluate hedge fund returns and focuses on practices relating to the valuation of portfolio holdings, use of fund assets, and adviser representations concerning portfolio performance, liquidity, investment strategy, valuation procedures, and conflicts of interest.²

While some of the cases involved serious violations, others were based solely on a fund manager's failure to implement adequate compliance procedures.³ The fact patterns in several of these cases demonstrate that even minor deficiencies noted during an SEC examination are more likely to lead to enforcement actions rather than just a deficiency letter if they are not fully and promptly rectified.

In the SEC release announcing these cases, Robert Kaplan, Co-Chief of the SEC Division of Enforcement's Asset Management Unit, stated: "[t]he failure to adopt and maintain adequate compliance policies and procedures is a significant violation of the federal securities laws. We will continue to work with our counterparts in the national exam program to identify investment advisers that put their investors at risk by failing to take their compliance obligations seriously."

The complaints and orders instituting proceedings filed by the SEC included the following allegations made against different fund managers:

- providing brokers with fictional mark-to-market quotes for illiquid securities holdings of a fund which were passed on to the fund's outside valuation agent and its auditor, causing the fund to overvalue these securities holdings by as much as \$163 million. *See Complaint, SEC v. Michael R. Balboa and Gilles T. De Charsonville*, (S.D.N.Y. 2011) (No. 11 Civ. 8731).
- misrepresentations over a five-year period concerning certain funds' longevity, performance and assets, the credentials and experience of the investment

¹ This memorandum provides general information on the subject matter described, should not be relied on for legal advice in any jurisdiction and may constitute attorney advertising.

² *See* SEC Release No. 2011-252 (Dec. 2, 2011).

³ *See* SEC Release No. 2011-248 (Nov. 28, 2011).

management team, and the length and scope of the due diligence process used for the selection of managers (including the manager of the Bayou Fund). *See* Complaint, *SEC v. Chetan Kapur, et al.*, (S.D.N.Y. 2011) (No. 11 Civ. 8094).

- fraudulently inducing twelve investors to invest \$2.2 million into a fund which invested almost all of its assets in microcap companies, while falsely representing that half of the fund's assets were liquid and could be marked to market each day; concealing from investors that one of the adviser's principals was involved in "at least one NASD customer arbitration asserting securities law violations against him, and at least one broker-dealer he controlled . . . had been repeatedly fined, censured and, ultimately, expelled by FINRA;" and concealing relationships between the adviser and companies in which the fund invested. *See In re Lead Dog Capital Markets LLC, et al.*, Securities Act Release No. 9277, Exchange Act Release No. 65,750, Investment Company Act Release No. 29,861, Advisers Act Release No. 3314, SEC Admin. Proc. File No. 3-14623 (Nov. 15, 2011).

- failure to adopt compliance policies and procedures after being informed of deficiencies during an SEC examination, including failure to establish, maintain, and enforce a written code of ethics, and failure to maintain and preserve certain books and records. The SEC also alleged that the chief compliance officer backdated his approval of an agreement which was produced to the SEC in response to a subpoena. *See In re OMNI Investment Advisors Inc. and Gary R. Beynon*, Exchange Act Release No. 65,837, Investment Company Act Release No. 29,873, Advisers Act Release No. 3323, SEC Admin. Proc. File No. 3-14643 (Nov. 28, 2011).

- failure to collect the required securities disclosure reports from employees and engaging in hundreds of principal transactions with the advisory clients' accounts without informing them or obtaining their consent; also, improperly charging undisclosed commissions on certain transactions in clients' wrap fee accounts. Some of these practices continued after the SEC issued a deficiency letter following an examination of the adviser. *See In re Feltl & Co., Inc.*, Exchange Act Release No. 65,838, Investment Company Act Release No. 29,875, Advisers Act Release No. 3325, SEC Admin. Proc. File No. 3-14645 (Nov. 28, 2011).

- failure to adopt compliance policies and procedures, and after the deficiency was raised in an SEC exam, failure to fully implement the compliance program; also, failure to collect written acknowledgements of receipt of the firm's the code of ethics from supervised persons and failure to periodically collect from access persons the required securities reports. *See In re Asset Advisors, LLC*, Investment Company Act Release No. 29,874, Advisers Act Release No. 3324, SEC Admin. Proc. File No. 3-14644 (Nov. 28, 2011).

- representations to the board of a registered investment company that a sub-adviser was providing research and other advisory services to the investment adviser when it was not, in fact, providing such services; the SEC also alleged that after the staff

inquired into the fund's relationship with the sub-adviser during an examination, the sub-adviser's services were terminated. *In re Morgan Stanley Investment Management Inc.*, Investment Company Act Release No. 29,862, Advisers Act Release No. 3315, SEC Admin. Proc. File No. 3-14628 (Nov. 16, 2011).

The increased likelihood of examinations resulting in enforcement actions, as demonstrated by these cases, highlights the need to review compliance procedures proactively and to consider conducting a mock exam in anticipation of an actual SEC examination, especially for newly-registered investment advisers.

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For more information about the case, please contact Ralph A. Siciliano (212 508-6718), a member of our firm's regulatory investigations practice.

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