

SEC Enforcement Division To Focus On Hedge Funds That Outperform The Market

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In response to the Madoff scandal, the Division of Enforcement for the U.S. Securities and Exchange Commission is focusing on hedge funds that outperform market indexes by 3% on a steady basis. This initiative has raised a number of questions.

Recently, during congressional testimony, Robert Khuzami, the Director of the Division of Enforcement for the U.S. Securities and Exchange Commission (SEC), faced tough questions regarding the SEC's response to the Madoff scandal. In response, Khuzami revealed an investigative initiative concerning hedge funds. Enforcement is now focusing on hedge funds that outperform "market indexes by 3% and [are] doing it on a steady basis." Khuzami referred to such performance as "aberrational," and stated that Enforcement is "canvassing all hedge funds" for such "aberrational performance."

This initiative raises a number of questions. For example, should skilled portfolio managers (and their investors) bear the burden and costs of an SEC investigation just because they have returned more than the market? Moreover, how and why did the Enforcement Division determine to set the threshold at three percent? Is this threshold appropriate and does it reflect "aberrational" performance, like Khuzami suggests?

The Focus on Hedge Funds

The hedge fund industry remains a top programmatic priority of the Division of Enforcement. (See McDermott's *On the Subject, [Hedge Fund Industry Will Be Under Close Scrutiny by SEC Division of Enforcement](#)*, April 19, 2010.). As discussed previously, the Division has established a special investigative unit, the Asset Management Unit, that focuses on hedge funds. Two other special investigative units, the Market Abuse Unit and Structured Product Unit, are also looking at issues potentially involving hedge funds. Enforcement's emphasis on hedge funds follows the SEC's high-profile debacle in the Madoff investigation, as well as other high-profile cases involving allegations of hedge fund improprieties, including the Galleon insider trading case. Indeed, these matters propelled Congress to include hedge fund regulation as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

Khuzami's recent testimony indicates that the Division of Enforcement is trying to devise new methods for identifying potential misconduct at hedge funds. Whether the hedge fund initiative will be more effective in identifying potential misconduct remains to be seen.

The Hedge Fund Initiative

Under its initiative, Enforcement will first attempt to identify hedge funds that are outperforming the "market." The Division will likely access services that track the performance of certain hedge funds. Additionally, Enforcement may send requests to numerous hedge funds seeking information related to investment performance. The Division will then use this information to determine where it should focus investigative resources. In doing this, the Division will need to analyze what is the appropriate benchmark to measure outperformance, what amount of outperformance should warrant added scrutiny, and consider other issues that may have enabled a particular manager to outperform including the skill of the manager and style of investing.

In determining whether a particular fund warrants further investigation, Enforcement may also consider other issues, such as, the size and experience of the fund's audit firm. The Division will also focus on whether the outperformance resulted from potential misconduct, such as, insider trading, improper valuation of investments, and/or manipulative trading.

Given the aggressive enforcement environment facing hedge funds, investment managers who outperform the market should be aware that the SEC may soon come knocking on their door. In any event, investment advisers should take a fresh look at their policies and procedures, especially, those relating to: (i) the documentation of investment decisions; (ii) valuation of assets; and (iii) trading of securities.

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