What’s Next? Hedge Fund Enforcement Priorities for 2013

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The SEC has brought more than 100 cases against hedge fund managers since 2010 and shows no signs of slowing down. No doubt, hedge funds will continue to be a top priority for the SEC’s Enforcement Division in 2013.

In recent remarks before the Regulatory Compliance Association, Bruce Karpati, Chief of the SEC Enforcement Division’s Asset Management Unit (AMU), discussed the agency’s priorities. He noted that that a significant majority of the SEC enforcement actions involve conflicts of interest, valuation, performance, and compliance and controls. However, Karpati also outlined several emerging trends that have raised red flags.

Lack of transparency in alternative investment vehicles. Alternative investment vehicles often involve complex, illiquid or opaque investments. While Karpati acknowledged that “the lack of transparency into their investment strategies and operations may occur for legitimate business reasons,” he also highlighted that the “potential for fraud is substantial.” “Even sophisticated investors can be defrauded through alternative investment vehicles, especially when their practices are not transparent to investors or regulators,” he noted.

Broader exposure to hedge funds. Ordinary investors are increasingly exposed to hedge funds through pensions, endowments, foundations, and other retirement plans. Karpati noted that private sector pension funds currently seek to allocate on average about 10% of their assets to hedge funds, and public sector pensions target an 8% allocation on average.

Retailization of hedge funds. The retailization of hedge funds has made it easier for unsophisticated investors to invest directly in hedge funds. Karpati specifically cited the elimination of the prohibition on general solicitation and advertising by the JOBS Act as a chief concern. “We understand that this may facilitate capital formation, but one of our concerns is that these retail-oriented hedge funds may be offered to investors that may have the financial wherewithal to meet accredited investor standards but are otherwise financially unsophisticated,” he stated.

Unregistered advisers. The SEC is “particularly aware of the risks posed by private funds advised by unregistered advisers.” Unregistered advisors that are not subject to the SEC’s rules and regulations “may not have effective compliance policies and procedures to prevent fraud and other violations, are not subject to inspection by exam staff, and need not comply with the commission’s advertising rules applicable to registered advisers.”

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