

Investment Management, Private Funds and Hedge Funds: What's Happening Now?

Regulatory Roundtable Discussion

Gregory J. Nowak
Jay A. Dubow
Richard J. Zack
Cassandre L. Juste

Pepper Hamilton LLP
Attorneys at Law

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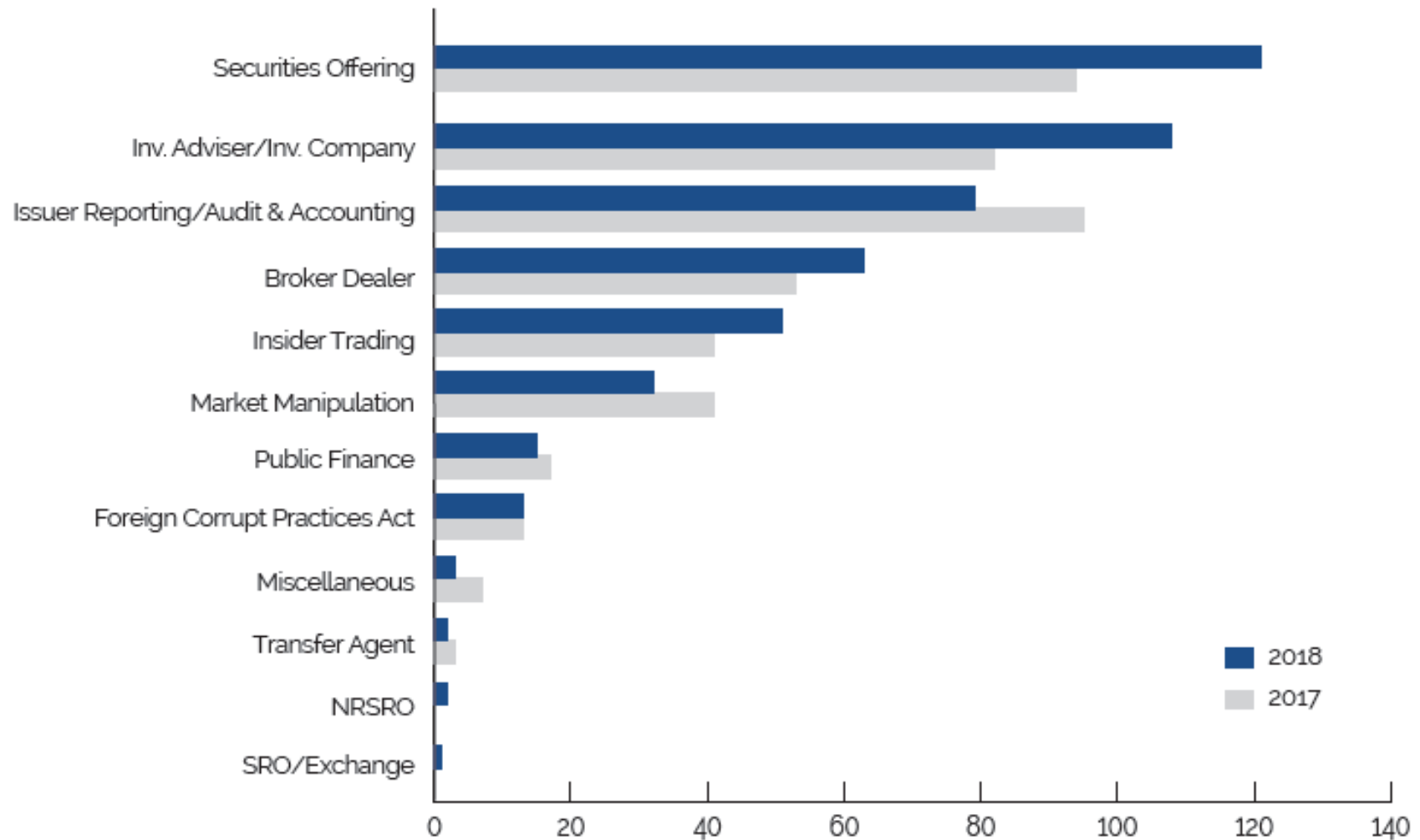
Presentation Overview

- ▶ SEC Enforcement Results
- ▶ CFTC Enforcement Results
- ▶ Recent Developments
- ▶ Overview of Enforcement Actions and Court Decisions
 - Sales practices
 - Defrauding clients
 - Initial coin offerings and digital assets
 - Cybersecurity
 - Municipal securities
 - 9th Circuit Opinion and the Potential Impact on Securities Settlements
- ▶ Compliance systems and internal investigations

SEC Enforcement Results

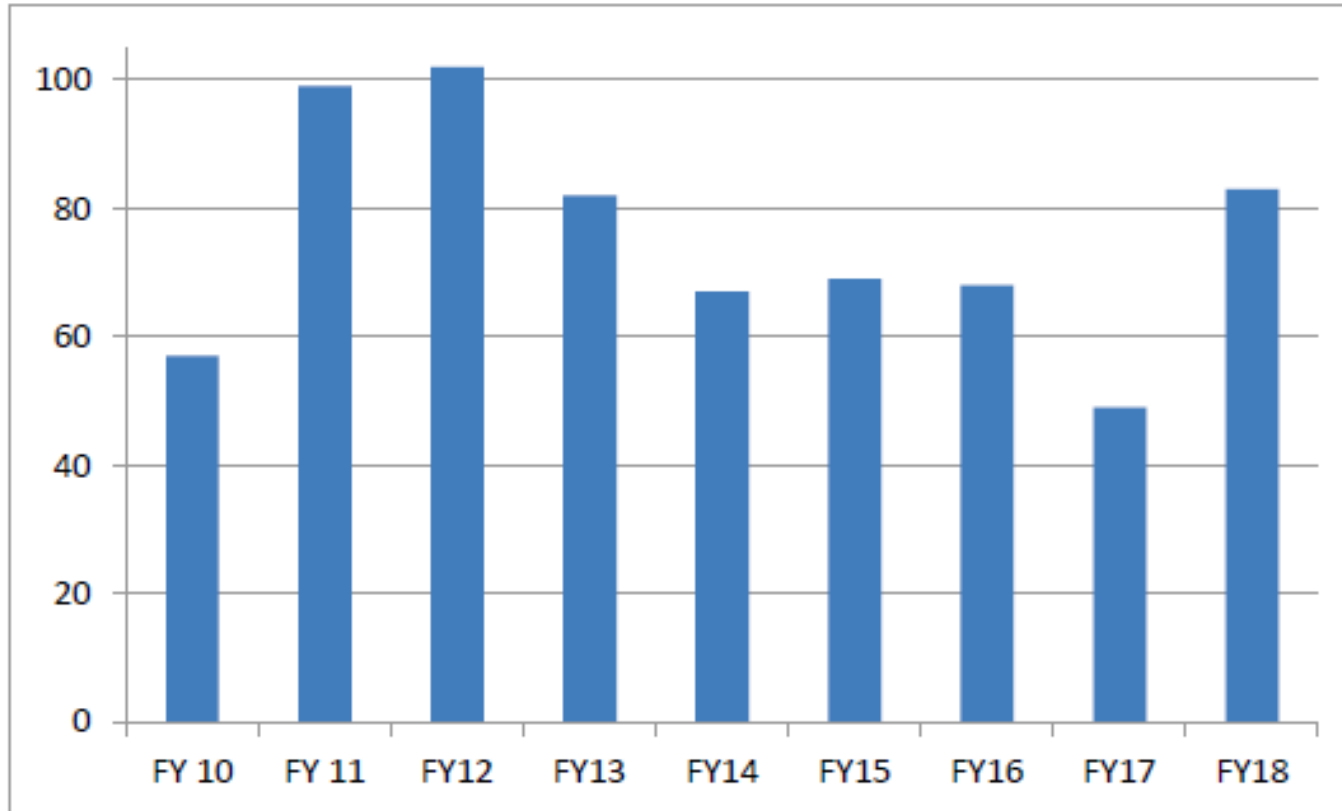
Fiscal Year	2016	2017	2018
Independent Enforcement Actions	548	446	490
Follow-on APs	195	196	210
Delinquent Filings	125	112	121
Total Actions	868	754	821
Disgorgement and Penalties Ordered	\$4.08 billion	\$3.78 billion	\$3.9 billion

SEC Enforcement Results (continued)



CFTC Enforcement Actions

- ▶ Total Number of Enforcement Actions: 2010-2018



CFTC Enforcement Actions (continued)

► Breakdown of CFTC Enforcement Actions

Case Category	Number
Manipulative Conduct, False Reporting, and Spoofing	26
Protection of Customer Funds, Supervision, and Financial Integrity	6
Retail Fraud	30
Illegal Off-Exchange Contracts, Failure To Register	11
Other Trade Practice, Including Wash Trades, Fictitious Trades, Position Limits	5
Misappropriation of Confidential Information	2
Reporting, Recordkeeping	3
Total	83

*“[R]etail investors believe the right way to regulate investment professionals is to have the **core obligations of investment professionals** match reasonable investor expectations...”*

Chairman Clayton (Aug. 22, 2018)

Failure to Safeguard Client Assets

IA Release No. 4985 / Aug. 15, 2018

- ▶ Registered representatives of a large, well-known brokerage stole more than \$1 million from client accounts
- ▶ Brokerage fined; reps criminally charged
- ▶ Sanctioned for underlying conduct *and* insufficient policies
 - Sections 206: Prohibited Transactions
 - Rule 206(4) – 7: Policies and Procedures

Testing Point: Do policies and procedures in place work as designed? Are they followed by personnel?

Best Execution

OCIE Risk Alert / July 11, 2018

- ▶ Obligation to provide best execution flows from fiduciary status of IAs, Section 206 of Advisers Act
- ▶ Best execution measured in light of the circumstances, not just best price
- ▶ Exam Priority of Staff

Testing Points:

- Execution Reviews (how often?)
- Consider all materially relevant factors (e.g., execution capability of BD, input from Portfolio Managers)
- Compare to other BDs
- Is there a Soft Dollar policy in place; is it followed?

Defrauding Advisory Clients

SEC Release 2018-195 / Sept. 14, 2018

- ▶ SEC charged advisory firm owner with selling high-risk securities to more than 120 advisory clients without disclosing 18% commission
- ▶ Defendants created false invoices and took other steps to conceal their involvement
- ▶ Charged with violating the antifraud and acting as unregistered broker

“Investment advisers must put their clients’ interests ahead of their own and make full and fair disclosure of financial conflicts of interest.”

Order Flow & Trade Reporting

Securities Act Release No. 10565 / Sept. 28, 2018

- ▶ Dual registrant offered order execution for other BDs and retail investors
- ▶ Routing code treated orders for which execution quality is required to be publicly reported differently from orders for which execution quality is not publicly reported
- ▶ Used routing tactic that caused market impact, resulted in less favorable execution prices for customers, and allowed wholesaler to profit internally – not disclosed
- ▶ Negligently violated Section 17(a)(2) of the Securities Act

Testing Point: Do systems perform as they are advertised to clients? Do advertisements omit material information?

Foreign Share Handling

Securities Act Release No. 10560 / Sept. 25, 2018

- ▶ BD issued thousands of ADRs that were not backed by the appropriate number of underlying shares
- ▶ Fifth enforcement action against a depository bank or BD for abusive practices involving ADRs to result from ongoing SEC investigation into ADRs
- ▶ Broker-dealer found in violation of Section 17(a)(3) of '33 Act, operating a fraud or deceit upon purchaser, and Section 15(b)(4)(E) of '34 Act, failure to supervise

Testing Point: Don't elevate form over substance; verify economic substance of transactions when possible

Fake Forex Trades

CFTC Release No. 7816-18 / Sept. 28, 2018

- ▶ U.K.-based brokerage and U.S. affiliate
- ▶ From 2008 to 2015, routinely placed fake bids and offers and fake trades in the foreign exchange options market to attract order flow
- ▶ Fake trades were known by executives
- ▶ Investigations by the CFTC and NYAG
- ▶ Fraud and supervision failures

Testing Point: “Culture of Compliance” starts at the top; verify substance, economic rationale when possible

*“Market professionals...need to act responsibly and hold themselves to high standards. To be blunt, from what I have seen recently, particularly in the **initial coin offering** space, they can do better.”*

Chairman Clayton (Jan. 22, 2018)

ICO Superstore

IC Release No. 33221 / Sept. 11, 2018

- ▶ Self-described “ICO Superstore” and owners acting as unregistered broker-dealers
- ▶ Promoted business as a way to purchase digital tokens during initial coin offerings (ICOs) and also to engage in secondary trading
- ▶ Received orders from more than 6,100 retail investors and handled more than 200 different digital tokens, including those characterized as securities
- ▶ Sanctioned under Section 206(4) of Adviser’s Act, for fraudulent, deceptive or manipulative practices

Testing Point: Registration (of securities, funds, advisers, etc.)
key to compliance in digital asset space right now; embrace
compliance

Digital Asset Fund Registration

IA Release No. 5004 / Sept. 11, 2018

- ▶ First-ever enforcement action relating to investment company registration violation by a digital asset hedge fund
- ▶ Fund operated as an unregistered investment company while falsely marketing it as the “first regulated crypto asset fund in the United States”
- ▶ Raised more than \$3.6 million over a four-month period in late 2017 while falsely claiming that the fund was regulated by the SEC and had filed a registration statement with the agency

“Investment advisers must be sure that the funds they offer adhere to the applicable registration obligations and must accurately represent their funds’ regulatory status to investors.”

*“In today’s environment, **cybersecurity** is critical to the operations of companies and our markets.”*

Chairman Clayton (Feb. 21, 2018)

Deficient Cybersecurity Procedures

IA Release No. 5048 / Sept. 26, 2018

- ▶ Dual-registrant
- ▶ Cyber intruders impersonated contractors, called help line requesting password resets, accessed thousands of accounts
- ▶ Violated Rule 30(a) of Reg. S-P
 - Cybersecurity procedures must be reasonably tailored to fit specific business model, and regularly updated
- ▶ Violated Rule 201 of Reg. S-ID
 - Requires BDs implement identity theft protection programs
 - First (but not last) SEC enforcement action involving Identity Theft Red Flag Rule

Testing Point: What are protocols for resetting a password? Are they written down, are they followed?

*“I have long believed that there should be additional regulatory focus on these important and growing markets...Indeed, the corporate and **municipal debt markets** are particularly significant to retail investors.”*

Chairman Clayton (Nov. 28, 2017)

Muni Flipping and Kickbacks

SEC Release 2018-153 / Aug. 14, 2018

- ▶ At least 18 individuals posed as retail investors to gain priority in bond allocations, then “flipped” the bonds to broker-dealers for a fee
- ▶ SEC also charged a municipal underwriter for accepting kickbacks from one of the flippers

Testing Point: Are KYC, client verification policies followed? Are policies commensurate with degree of risk (e.g., compare muni bonds to cannabis-related businesses)?

Muni-Issuer Disclosure

Amendments to Rule 15c2-12

- ▶ Amendments in addition to existing disclosure obligations in Rule 15c2-12
- ▶ Requires disclosure of material financial obligations that could impact an issuer's liquidity, overall creditworthiness, or rights of existing security holders
 - e.g., debt obligations; derivative instruments; guarantees; defaults; accelerations
 - NOT ordinary operating liabilities, other muni issuances as to which an Official Statement has been delivered
- ▶ Materiality assessed under *TSC Industries* standard

*“The **Volcker Rule**...asks regulators to separate the risk-taking functions of a firm from those backed by the government.”*

Commissioner Jackson (June 5, 2018)

Volcker Rule

A (very) broad overview

▶ Proprietary Trading

- Trading for own account on short term basis
- Consider exemptions (e.g., underwriting, market making, bona fide hedging)
- **Testing Point:** how is it determined if a trade falls into one of the exemptions; is determination made before or after trade is made? What are reporting, recordkeeping procedures for each?

▶ Covered Funds

- Funds that would be investment companies but for § 3(c)(1) or § 3(c)(7) of 1940 Act
- Certain commodity pools
- “foreign funds”
- **Testing Point:** Who is in charge of Volcker Rule compliance?

▶ Possible amendments loosening compliance burdens

9th Circuit Opinion and its Potential Effect on Securities Settlements

Karim Khoja v. Orexigen Therapeutics Inc. et al.,

- ▶ Class action brought against biotechnology company, Orexigen Therapeutics Inc.
- ▶ After class action was brought the company requested that the court consider 22 documents and treat such documents as if submitted with the complaint. The court granted the request and later dismissed the plaintiffs' case for failure to state a claim.
- ▶ On appeal, a three-judge panel held that the lower court improperly considered information outside of the complaint in dismissing the case.
- ▶ The 9th Circuit found that lower courts may be abusing the ability to take judicial notice or consider documents, which is only intended for undisputed facts of the case.
- ▶ **Implications:** Lower courts may allow more cases to proceed beyond a motion to dismiss, which could lead to more settlements.

Compliance Culture

- ▶ Prosecutors and regulators will look at compliance systems in deciding what actions to take
- ▶ Compliance personnel must have the proper stature in the organization and background
- ▶ Compliance systems must evolve to deal with new threats and growing company
- ▶ Firms that have invested in compliance can point to these systems in dealing with regulator or investigator deciding on what action to take
- ▶ Firms that have systems in place are more likely to be able to demonstrate that employee misconduct is not attributable to the firm

Internal Investigations

Protecting the Firm when Things Go Wrong

- ▶ When things go wrong, a firm will often be judged more by how it reacts to misconduct than by the underlying misconduct
- ▶ When misconduct is discovered devote the proper resources to remedying it
- ▶ When conducting an investigation, control disclosure of confidential information as much as possible
- ▶ Select the proper investigator, making sure that the investigation will have credibility with regulators and prosecutors

Questions & Answers

Gregory J. Nowak

Partner, Financial Services

212.808.2723

nowakg@pepperlaw.com

- ▶ Concentrates his practice in securities law, particularly in representing investment management companies and other clients on matters arising under the Investment Company Act of 1940 and the related Investment Advisers Act of 1940
- ▶ Represents many hedge funds and other alternative investment funds in fund formation and investment and compliance matters, including compliance audits and preparation work
- ▶ Writes and speaks frequently on issues involving investment management, health care and other matters. Mr. Nowak is the author of five books on hedge funds.



Jay A. Dubow

Partner, White Collar Litigation and Investigations

215.981.4713

dubowj@pepperlaw.com

- ▶ Focuses his practice on complex business litigation, with a special emphasis on defending against shareholder derivative and securities class action litigation and representing clients involved in investigations by the U.S. Securities and Exchange Commission, the Pennsylvania Department of Banking and Securities and various self-regulatory organizations, including the Financial Industry Regulatory Authority, Inc.
- ▶ Leader in the American Bar Association's Business Law Section and currently serves as chair of the Securities Litigation Subcommittee of the Business and Corporate Litigation Committee.



Richard J. Zack

Partner, White Collar Litigation and Investigations

215.981.4726

zackr@pepperlaw.com

- ▶ Concentrates his practice on representing businesses, financial institutions, educational institutions, nonprofits and individuals facing investigation by federal and state law enforcement authorities, and government regulatory agencies.
- ▶ Represents businesses and individuals who have been victims of crimes. He has extensive experience in representing financial service firms before federal and state prosecutors and regulators and firms facing investigations related to consumer finance and transactions involving foreign entities.



Cassandre L. Juste

Associate, Financial Services

215-981-4216

justec@pepperlaw.com

- ▶ Associate in the Financial Services Practice Group with Pepper Hamilton LLP, resident in the Philadelphia office.
- ▶ Focuses her practice on entities regulated under the Investment Company Act of 1940 and the Investment Advisers Act of 1940. She has advised clients on the launch of new funds and regulatory and compliance matters relating to existing funds.



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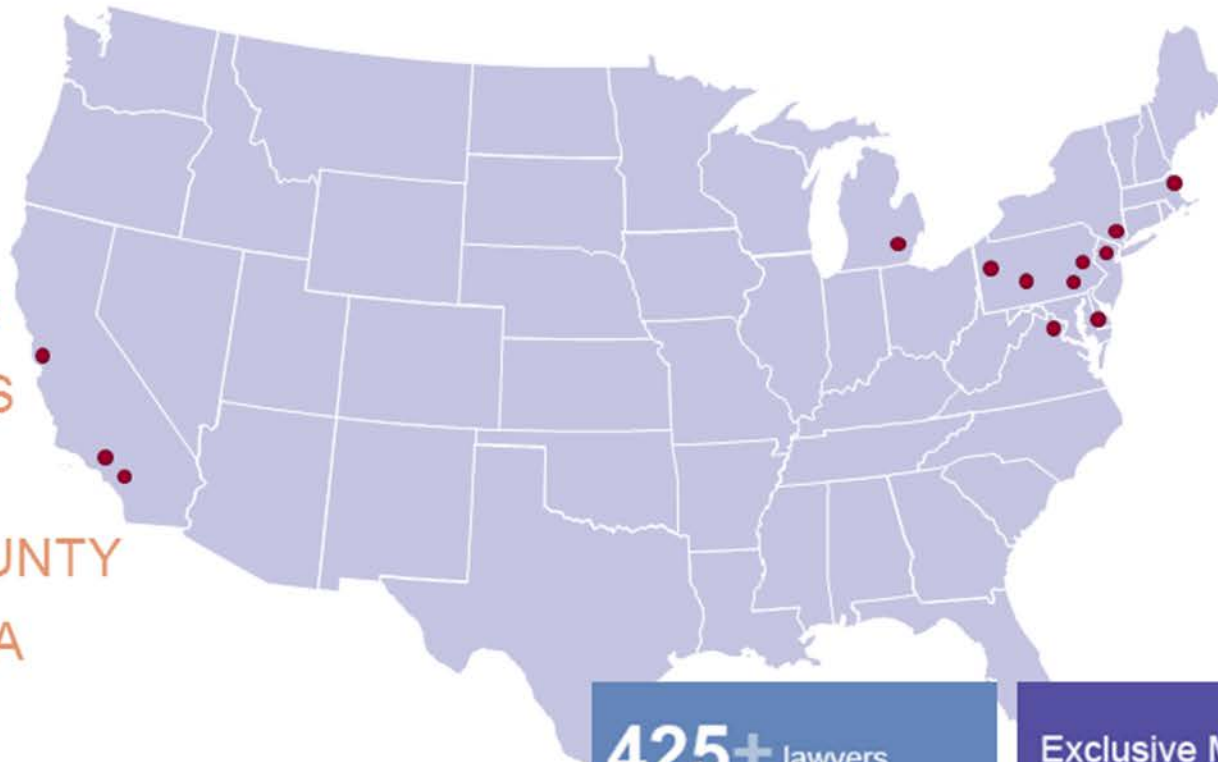
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