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ENFORCEMENT

In the Crosshairs: The Asset Management Industry

BY TERENCE HEALY AND AMY GREER

The asset management industry has never been far from the gaze of regulators. But when the Securities and Exchange Commission ("SEC") opened a special Asset Management Unit in 2010, it was clear the industry would be the subject of increased federal scrutiny. Since that time, there has been a steady rise in enforcement actions against asset managers and investment companies as regulators try to grapple with this complex and growing area. Add in new registration requirements for some private fund advisers under the Dodd-Frank Wall Street Reform and Consumer Protection Act, plus removing limits on general solicitations under the Jumpstart Our Business Startups Act, and the reasons for greater regulatory focus on this sector become apparent.

Terence Healy is a partner at Reed Smith LLP in Washington. He regularly represents financial institutions and individuals in matters against the Securities and Exchange Commission, Department of Justice, and other regulators. Before joining Reed Smith, Mr. Healy was Senior Assistant Chief Litigation Counsel for the SEC's Division of Enforcement.

Amy Greer is a Partner in Reed Smith's New York office and co-leads the Firm's Securities Litigation and Enforcement Practice. Prior to joining Reed Smith, Ms. Greer served as Chief Trial Counsel in the SEC's Philadelphia Regional Office, handling complex litigated and investigative matters and managing the Office's trial program. Her current practice focuses largely on regulatory investigations—SEC, FINRA, DOJ, and State - internal investigations, and litigated securities matters.

The asset management industry now controls a large percentage of investor wealth for both retail and institutional investors, with increasingly complex products offered even at the retail level. The size of industry—with nearly 11,000 registered investment advisors—and the complexity of some of the products offered to investors have posed a challenge to regulators. To confront this challenge, the SEC and other agencies have undertaken a number of targeted enforcement initiatives as they try to get their arms around this burgeoning industry. This regulatory momentum will continue to build.[1]

Asset Management Writ Large. In the decades preceding the financial crisis, the asset management industry grew dramatically. Both in the U.S. and abroad, total assets under management ("AUM") skyrocketed, fueled

[1] Indeed, in recent testimony before Congress, SEC Chairman Mary Jo White identified increasing the agency's examination program of investment advisors as one of her top priorities. Mary Jo White, Testimony before the Subcommittee on Financial Services and General Government, Committee on Appropriations, United States House of Representatives, May , 2013.

by long periods of easy credit and increasing individual net worth.[2] Though the industry was battered in the crisis years, it bounced back with a storm, and by 2012 total AUM exceeded pre-crisis levels.[3] Today, the global fund industry controls a staggering $120 *trillion* in investor assets,[4] with asset managers in the U.S. alone responsible for more than $50 trillion in AUM.[5]

Broadly speaking, the modern asset management industry can be divided into two groups, institutional asset management and retail asset management. The institutional group, which includes hedge funds, private equity funds, and advisory firms, deals directly with other institutions.[6] The retail asset management group, which includes all mutual funds and pension funds, maintains individual investor accounts and operates under a generally higher regulatory structure.[7] Few firms manage assets for both retail and institutional clients.[8]

Within these groups, the industry encompasses a range of firms and classes of investment funds. Many banks have separate asset management divisions that offer customers wealth management services.[9] These services can be offered through collective investment funds or separate accounts. Similarly, many insurance companies also provide asset management services to their customers, such as retirement planning. Dedicated asset management companies, depending on their structure, can also offer collective investment funds or retirement accounts to customers. Most dedicated asset management companies are registered as investment advisors.[10]

The sheer size of the industry poses a regulatory challenge. By September 2010, the number of registered investment advisors (''RIAs'') had grown to nearly 12,000.[11] Even in the recession years following the financial crisis, when total AUM dipped across the industry, the number of RIAs continued to increase. The overall number of RIAs has decreased somewhat since 2010, as Dodd-Frank has allowed advisors with less than $100 million in AUM to bypass the SEC and register with state authorities, but the total still stands at nearly 11,000. In addition to RIAs, the SEC is charged with oversight of approximately 9,700 mutual and exchange-traded funds and 30,000 private funds.[12]

Against these tens-of-thousands of funds and advisors, the SEC is armed with a staff of only about 460 professional examiners.[13] The ratio of examiners to regulated entities makes any regular, meaningful examination of all funds and advisors an impossibility, particularly given that, as AUM increase, the complexity and time required to complete an exam increase correspondingly.[14] As a result, in fiscal year 2012, the SEC was only able to examine about 8 percent of registered advisors. So what is a regulator to do?

Search for the Holy Grail. The SEC has described early detection and prevention of fraud as the ''holy grail of securities law enforcement.''[15] To try to grasp this elusive prize—and to get a handle on a $50 trillion domestic industry—the SEC and other regulators have employed a series analytical tools and enforcement initiatives targeted at asset managers. These efforts have included:

Aberrational Performance Inquiry. In March 2011, the SEC unveiled an Aberrational Performance Inquiry designed to identify funds that consistently outperformed standard market indexes. Those funds whose performance stood out from the crowd would be targeted for closer examination. This initiative first appeared to bear fruit in December 2011 when the Commission charged two hedge fund managers, Michael Balboa and Gilles De Charsonville, with fraud for overvaluing the returns of a fund which, at its peak, claimed to have more than $840 million in AUM.[16] On the same day, the SEC charged four other fund managers for similarly overvaluing the performance of their funds and similar misdeeds.[17] The Commission stated each of these actions grew out of its Aberrational Performance Inquiry.

In October 2012, the SEC announced another enforcement action against a hedge fund advisory firm and its executives arising from the Aberrational Performance Inquiry. In that case, the Commission charged Yorkville Advisors LLC and its president, Mark Angelo, and chief financial officer, Edward Schinik, with fraud for misleading investors as to their funds' valuation procedures and investments.[18] Bruce Karpati, then-chief of the SEC's Asset Management Unit, said the agency's analytical tools put Yorkville ''front and center on our

[2] *See* Michael Pinedo, *Global Asset Management: Strategies, Risks, Processes and Technologies* 9 (Palgrave Macmillan 2013).

[3] *See* Sujata Rao, *Global Fund Industry Rebound,* Reuters News, November 13, 2012

[4] *See id.*

[5] Office of Financial Research, *Asset Management and Financial Stability* 4 (September 2013).

[6] *See* Michael Pinedo, *Global Asset Management: Strategies, Risks, Processes and Technologies* 8-9 (Palgrave Macmillan 2013).

[7] *Id.*

[8] *Id.*

[9] Banks generally are not required to register their wealth management services with the SEC, unless those services are being provided to a registered investment company. Office of Financial Research, *Asset Management and Financial Stability* 27 (September 2013).

[10] *Id.*

[11] At the close of the 2010 fiscal year (Sept. 30, 2010), there were 11,888 investment advisors registered with the SEC. *See* SEC Division of Investment Management, *Study on Enhancing Investment Adviser Examinations* 8 (Jan. 2011).

[12] *See* Mary Jo White, Remarks at National Society of Compliance Professionals National Membership Meeting, Oct. 23, 2013.

[13] In fact, while the number of RIAs and AUM grew steadily in the years leading to the financial crisis, the number of SEC examiners actually decreased by 13 percent. *See* SEC Division of Investment Management, *Study on Enhancing Investment Adviser Examinations* 11 (Jan. 2011). Even today, the SEC still has fewer examiners than it did in 2005.

[14] As an asset manager grows larger, the size and complexity of their operations generally increase also. *Id.* at 8-9. Larger asset managers will typically have more clients, more affiliated business activities, and more complex investment strategies. *Id.* All of these factors affect the complexity of the regulator's examination.

[15] SEC Press Release, *SEC Charges Multiple Hedge Fund Managers with Fraud in Inquiry Targeting Suspicious Investment Returns* (Dec. 1, 2011).

[16] *Id.*

[17] *Id.*

[18] SEC Litigation Release, *SEC Charges Hedge Fund Adviser and Two Executives with Fraud* (Oct. 17, 2012).

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radar screen,'' leading ultimately to their uncovering the fraud.

The Commission will continue to look for funds whose performance is ''aberrant'' and target those funds for closer scrutiny. This may lead to more frauds being discovered in an earlier stage. It may also mean that many successful funds, and funds with unique investment models, will increasingly find the regulators showing up at their doors for examinations.

Private Equity. Despite controlling more than a $1 trillion in assets, the private equity industry traditionally received little attention from regulators. Private equity firms generally do not trade securities and, unlike banks and hedge funds, private equity was never accused of being a root cause of the financial crisis. But the industry's time in the shadows may be coming to a close. The SEC has reported that, in total AUM, private equity now equals, and may exceed, the entire hedge fund industry.[19] This fact alone provides reason for increased scrutiny from regulators. Bruce Karpati also stated in January 2013 that ''private equity has other unique characteristics that may make the industry more susceptible to fraud,'' including the lack of transparency in how portfolio companies are controlled.[20]

To address these issues, the SEC's Asset Management Unit undertook a Private Equity Initiative in which it analyzes portfolio data to identify fund managers who have assets under management but appear unable to raise follow-on vehicles. The SEC believes these so-called ''zombie funds'' may be more likely to lead to misuse of investor funds.[21] The SEC staff has identified other areas of concern in the private equity industry, including valuation of illiquid securities, disclosure and allocation of fees and expenses, and related-party transactions.[22] This shows the SEC is now looking at private equity beyond market-facing activity, such as insider trading, to examine more closely the business operations of firms.

In March of last year, the SEC announced the filing of settled charges against two private equity firms and some employees. The Commission alleged that Ranieri Partners, a New York-based private equity firm, and one of its senior managing partners, Donald Phillips, aided and abetted violations of Section 15(a) of the 1934 Securities Exchange Act by allowing one of Phillips' friends, William Stephens, to act as an unregistered broker soliciting investors.[23] The SEC charged that Stephens, while acting as a ''finder'' for private funds which affiliates of Ranieri managed, actively solicited investors and in return received transaction-based compensation totaling approximately $2.4 million.[24]

On the same day as the charges against Ranieri, the SEC announced settled charges against Oppenheimer Asset Management and Oppenheimer Alternative Investment Management, both registered investment advisors, for violating the antifraud provisions of the 1933 Securities Act and the 1940 Investment Advisors Act by misleading investors as to the valuation methods used to value some of the underlying portfolio assets in a private equity fund they managed.[25] In filing the charges, Julie Riewe, then-deputy chief of the SEC's Asset Management Unit, warned that private equity managers may become ''incentivized'' to artificially inflate portfolio valuations.[26] This comment, which mirrors others from the Enforcement Division staff, shows valuation will continue to be a focus area for regulators.

Insider Trading. Insider trading has been called ''the drug crime of the financial world'' and continues to be a high priority for both the Justice Department and SEC. These cases, which are often well covered in the media, are popular with regulators. George Canellos, former co-director of the SEC's Division of Enforcement, said in March 2013 that ''sophisticated hedge funds'' pose risks for insider trading and that the SEC would be bringing more cases in that area.[27] Over the past two years, there has been an explosion of blockbuster case filings, settlements, and trials in the area of insider trading, many of which arose out of the asset management industry.

In November 2012, the government unveiled the mother-of-all insider trading cases when it charged some affiliated entities of the Connecticut hedge fund SAC Capital Advisors (''SAC''), and one of its employees, with insider trading.[28] The government alleged the defendants made a record $276 million in illicit profits and losses avoided through a scheme to trade based non-public information involving the clinical trials of an Alzheimer's drug. The hyperbole from the regulators in announcing the charges—in which they referred to ''yet another corrupt hedge fund manager''[29]—underscores the focus on insider trading in the asset management industry, particularly as to hedge funds.

The government's pursuit of SAC continued throughout 2013. In July, the Justice Department unsealed an indictment charging the company with securities fraud and alleging a pattern of ''pervasive'' insider trading ''on a scale without known precedent in the hedge fund

[19] *See* Bruce Karpati, Remarks at the Private Equity International Conference, Jan. 23, 2013.

[20] *Id.*

[21] *Id.*

[22] *Id.*

[23] SEC Press Release, *SEC Charges Private Equity Firm, Former Executive, and Consultant for Improperly Soliciting Investments* (Mar. 11, 2013).

[24] *In the Matter of Ranieri Partners LLC and Donald W. Phillips*, Admin. Proceeding File No. 3-15234 (Mar. 11, 2013).

[25] SEC Press Release, *SEC Charges New York-Based Private Equity Fund Advisers with Misleading Investors about Valuation and Performance* (Mar. 11, 2013). In August 2013, the SEC instituted administrative proceedings against the portfolio manager of one of the underlying funds, Brian Williamson, for making misrepresentations to investors as to valuation methods. *In the Matter of Brian Williamson*, Admin. Proceeding File No. 3-15430 (Aug. 20, 2013).

[26] *Id.*

[27] George Canellos, Remarks at the SIFMA Compliance and Legal Society Annual Seminar, Mar. 18, 2013.

[28] On November 20, 2012, the SEC charged CR Intrinsic Investors, LLC, a Connecticut hedge fund advisory firm; Mathew Martoma, its former portfolio manager, and Dr. Sidney Gilman, a Michigan medical consultant, with insider trading. *See* SEC Press Release, *SEC Charges Hedge Fund Firm CR Intrinsic and Two Others in $276 Million Insider Trading Scheme Involving Alzheimer's Drug* (Nov. 20, 2012). On the same day, the Department of Justice unsealed a criminal indictment against Matthew Martoma charging him with securities fraud. He was arrested at his home in Florida that day. The SEC later amended its complaint to add claims against CR Intrinsic Investments, LLC, SAC Capital Advisors, LLC, SAC Capital Associates, LLC, SAC International Equities, LLC, and SAC Select Fund, LLC as relief defendants.

[29] *Id.*

industry.''[30] In November, SAC agreed to plead guilty and pay a landmark $1.8 billion in penalties. In other proceedings, Michael Steinberg, a former portfolio manager of an SAC affiliate, was convicted of insider trading in December.[31]And in February 2014, Michael Martoma, the portfolio manager at the center of the $276 million insider trading scheme disclosed in November 2012, was convicted of securities fraud.

Beyond SAC, the SEC and DOJ continue to pursue insider trading investigations across the asset management industry. Insider trading will remain a core priority with regulators.

Compliance. The role of compliance in the financial services industry continues to evolve. Following the financial crisis, regulators concluded many firms lacked sufficient internal risk management and compliance operations.[32] Under Dodd Frank, Congress increased the responsibilities of compliance officials, requiring closer involvement in basic business operations.[33] Just as these responsibilities continue to expand and become more complex—with significant new statutes and regulations to integrate into compliance programs, both domestically and (for larger organizations) abroad—regulators have come to hold compliance officials more accountable for violations at their firms.

Last year, the SEC brought a series of cases against compliance officers and their firms alleging failures in their compliance programs. In July, the Commission charged Comprehensive Capital Management Inc. and Ronald Rollins, its chief compliance officer, for failure to supervise an employee who used falsified authorization forms to transfer more than $16 million from advisory accounts into accounts he controlled.[34] The SEC alleged Rollins aided and abetted violations of the Custody Rule, books and records provisions, and some compliance provisions of the Investment Advisors Act.[35]

In October, the SEC brought enforcement proceedings against three investment advisory firms, Modern Portfolio Management Inc., Equitas Capital Advisers LLC, and Equitas Partners LLC, for ignoring problems with their compliance programs.[36] The actions arose out of the Commission's Compliance Program Initiative which targets firms that have been previously warned of compliance deficiencies but failed to address them. The SEC alleged these compliance deficiencies allowed the firms to commit various violations, such as misrepresenting AUM, conflicts of interest, and improper client billing.[37]

These cases, where compliance officers were held liable for failing to prevent the underlying—even willful—violations at their firms, have sent a chilling message to the compliance profession. They also represent another area where regulators will demand more accountability from the asset management industry.

Custody. The safety of client assets is considered ''the heart of the relationship between [investment] advisors and their customers.''[38] An adviser is considered to have custody if it holds client funds, directly or indirectly, or securities or has authority to obtain possession of them.[39] The Custody Rule under the Investment Advisors Act[40] provides for the safekeeping of client assets at qualified custodians. The SEC's National Examination Program has found ''widespread and varied non-compliance with elements of the custody rule.''[41] Improving compliance with the Custody Rule remains an enforcement priority for the SEC.

In 2010, the SEC strengthened the Custody Rule by requiring all advisers with custody of client assets to undergo annual ''surprise exams'' to certify those assets. Advisers must also have a reasonable basis to believe that a qualified custodian is sending investors account statements at least quarterly.[42]

In October, the SEC charged three investment advisory firms with violating the Custody Rule. The Commission alleged Further Lane Asset Management LLC, GW & Wade LLC, and Knelman Asset Management Group LLC failed to maintain client assets with qualified custodians or to engage independent accountants to conduct surprise exams.[43] The firms agreed to settle administrative proceedings.

Ensuring more consistent compliance with the Custody Rule will continue to be a priority of the SEC across its exam and enforcement programs.

Valuation. Valuation of assets has long been a focus of regulators. The SEC has warned that with hedge funds, based on their compensation structures, fund managers may have ''incentives'' to overstate their AUM.[44] The SEC has brought a number of cases (some of which are discussed above) against funds and fund managers challenging the accuracy of valuations and compliance with valuation procedures. The Commission's commitment in this area was underscored in 2012 when it took the step of charging eight former members of the Morgan Keegan board of directors with failing to oversee valuation procedures at the firm's underlying funds.[45] The SEC will continue to give close scrutiny to valuation issues across the asset management industry.

General Solicitations. One of the most significant recent changes to the securities laws came through the JOBS Act, which removed the decades-old prohibition on general solicitation of investors for private securities

[30] Indictment, *United States v. SAC Capital Advisors LP*, No. 13-CR-00541 (SDNY Jul. 25, 2013).

[31] DOJ Press Release, *SAC Capital Portfolio Manager Michael Steinberg Found Guilty in Manhattan Federal Court of Insider Trading Charges* (Dec. 18, 2013).

[32] *See* Carlo V. di Florio, Remarks at the Compliance Outreach Program (Jan. 31, 2012).

[33] *See* SIFMA, *The Evolving Role of Compliance* 1 (Mar. 2013).

[34] *In the Matter of Ronald Rollins,* Admin. Proceeding File No. 3-15392 (Jul. 29, 2013).

[35] *Id.*

[36] SEC Press Release, *SEC Sanctions Three Firms Under Compliance Program Initiative* (Oct. 23, 2013).

[37] *Id.*

[38] SEC Press Release, *SEC Charges Three Firms With Violating Custody Rule* (Oct. 28, 2013).

[39] Rule 206(4)-2(d)(2) to the Investment Advisers Act of 1940.

[40] Rule 206(4)-2 to the Investment Advisers Act of 1940.

[41] SEC Office of Compliance Inspections and Examinations, National Examination Program Risk Alert, *Significant Deficiencies Involving Adviser Custody and Safety of Client Assets* (Mar. 4, 2013).

[42] *See* SEC Press Release, *SEC Charges Three Firms With Violating Custody Rule* (Oct. 28, 2013).

[43] *Id.*

[44] Bruce Karpati, Remarks before the Regulatory Compliance Association (Dec. 28, 2012).

[45] SEC Press Release, *SEC Charges Eight Mutual Fund Directors for Failure to Properly Oversee Asset Valuation* (Dec. 10, 2012).

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offerings.[46] The SEC rules implementing some of the major provisions of the JOBS Act went into effect in September 2013, and some private funds are now free to advertise and solicit investors directly. Under these provisions, sales are limited to accredited investors and an issuer must take reasonable steps to verify that all purchasers of the securities are accredited.

Even as the ban on general solicitations was being lifted, the SEC was quick to emphasize that it would look closely at general solicitations to address any frauds as they occur.[47] Private fund managers should expect the SEC to be very proactive in monitoring this area.

As these various initiatives show, the asset management industry will be in the spotlight of regulators for years to come, and to a degree not seen in the recent past. The last three fiscal years have shown a near doubling in the number of cases the SEC brought against investment advisors and investment companies compared to 2009 and earlier. This trend is likely to continue as regulators try to tackle an industry with more than $50 trillion in assets under management in the U.S. alone.

[46] The SEC reports that private funds raised over $700 billion in 2012 under Rule 506 of Reg D. *See* Mary Jo White, Remarks at the Managed Funds Association Outlook 2013 Conference (Oct. 18, 2014).

[47] *See id.*