MANAGING RISK: A GUIDE FOR INVESTMENT ADVISERS

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As an investment adviser, you make your living by predicting, weighing, and ranking risks for your clients. But do you pay equal attention to the risks that you and your firm face? As we leave behind the tumultuous Aughts, now is the perfect time to revisit your compliance policies and internal controls to ensure that you are doing everything possible to safeguard your firm's future.

This is particularly true given recent changes at the Securities and Exchange Commission (the "SEC"). During 2008 and 2009, the SEC became the focus of intense national scrutiny and skepticism. There was a sense that the SEC had not fulfilled its mandate of protecting investors and enforcing the securities laws. During 2009, the SEC underwent a changing of the guard at the top levels. The SEC's new leadership –Chairman Mary L. Shapiro and Director of the Division of Enforcement Robert Khuzami – has pledged to improve the agency's detection and enforcement efforts. And as we move into 2010, the SEC will have significantly more resources to do so. On December 16, 2009, President Obama signed the appropriations bill for fiscal year 2010 funding the SEC at nearly $1.12 billion which represents an increase of $100 million (9.7%) over Obama's budget request and $156 million (16%) over the SEC's fiscal year 2009 level. The President's proposed budget for 2011 would increase funding by an additional 11% to $1.23 billion. With increased focus and increased funding, the SEC promises to be active in 2010 and beyond.

Although we encourage you to holistically assess the effectiveness your controls, there are some areas that deserve your special attention—because these areas are already receiving special attention from the SEC. For this article, we examined the SEC's

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enforcement actions, speeches, press releases, and special projects to determine where the SEC has been (and will likely continue to be) most active. Through our research, we identified three topics—insider trading, asset valuation, and custody of assets—that appear to be of particular interest to the SEC and provide suggestions on how you may avoid ending up in the SEC's crosshairs.

I. Insider Trading

A market is likely to be efficient if investors are on an even playing field, informationally speaking. Conversely, if there is an information imbalance, a market is likely to be inefficient—and potentially dangerous for the uninformed. Therefore, one of the SEC's mandates is to ensure that all investors have equal access to market information. To accomplish this, the SEC is currently engaged in what Khuzami has called a "concerted effort to root out insider trading on Wall Street and in the hedge fund industry."

During 2009, there have been a large number (and a number of large) enforcement actions against funds and individuals accused of insider trading. There have also been some important changes in the way that the SEC detects and investigates insider trading that should be of interest to the industry.

A. SEC v. Galleon Management, LP *et. al.*

On October 16, 2009 (and in an amended complaint filed November 5, 2009), the SEC filed the largest hedge fund insider trading case in history against billionaire Raj Rajaratnam, his hedge fund advisory firm Galleon Management LP, other funds, and 14 additional individuals. Included among the individual defendants are prominent hedge fund managers and senior executives at major companies IBM, Intel, and McKinsey & Company. The SEC alleges that Rajaratnam tapped into his network of friends and close business

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associates to obtain insider tips and confidential information about corporate earnings or takeover activity at several companies (including Google, Hilton and Sun Microsystems) and that Rajaratnam and others used the non-public information to illegally trade. The SEC alleges that the scheme generated more than $33 million in illicit gains.

Galleon is notable because of the high profile defendants and the huge profits they allegedly made, but it has created a true firestorm because of the investigatory methods the government used over a period of nearly two years to build the case. For the first time, the government adopted techniques—wiretaps, cooperating witnesses, surreptitious consensual recordings—more commonly associated with organized crime investigations.

According to Mr. Rajaratnam's lawyers, the government also created a sham investigation of an unrelated hedge fund. Under the guise of that investigation, the government "interviewed numerous witnesses under oath, including Mr. Rajaratnam, and questioned them about conduct alleged in the Amended Complaint. In response to requests made by the SEC, Galleon produced tens of thousands of pages of documents." They have argued that the wiretap violated Title III and Mr. Rajaratnam's constitutional rights because, when the Government sought authorization to intercept his communications, they did not advise the Court that they were also using these alternative investigatory methods

The government was quick to note in its press releases and case announcements the use of wiretapping to aid in the investigation. Everyone in the industry must assume that the agencies are undeterred. In fact, the use of these investigatory methods has been trumpeted by law enforcement as a "wakeup call" for those who are privy to inside information. Preet Bharara, the new U.S. attorney for the Southern District of New York, put it succinctly: "as the defendants in this case have now learned the hard way, they may have been privy to a lot

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of confidential corporate information, but there was one secret they did not know: We were listening. Today, tomorrow, next week, the week after, privileged Wall Street insiders who are considering breaking the law will have to ask themselves one important question: Is law enforcement listening?"

B. SEC v. Stephanou, *et. al.*

The SEC filed a less hyped, but perhaps more portentous case on February 5, 2009. In the complaint, the SEC alleged that an international insider trading ring comprised of seven individuals generated more than $11.6 million in illegal profits and losses avoided from at least November 2005 through December 2006. The defendants included an Associate Director of Mergers and Acquisitions at UBS Investment Bank, a Managing Director in the Corporate and Mergers and Acquisitions group at Blackstone Advisory Services, L.P., and a Managing Director at Jefferies & Company, Inc., and were from locales as far-flung as Cyprus, the United Kingdom, and Brooklyn. The participants allegedly traded on material, non-public information regarding at least three acquisitions, including the acquisition of Albertson's, Inc. and National Health Investors, Inc.

The significance of the way that the SEC uncovered this case cannot be overstated. Historically, the self-regulatory organizations have been the "front lines" of surveillance for insider trading. The SEC has relied on the self-regulatory organizations to identify suspicious trading activity and refer it to the SEC for investigation. The referrals were traditionally made on a single security basis. When the SEC received a referral, they submitted a "Bluesheet" request for trading in the particular security. This means that the SEC investigated each instance of suspected insider trading as a stand alone matter.

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This case was entirely different. The SEC did not rely on referrals from self-regulatory organizations, tips from individuals, or any of the other traditional leads to identify this insider trading ring. In fact, none of the defendants had ever been on the SEC's radar. Instead, the case began with the submission of dozens of separate Bluesheet requests. These requests were then submitted to automated serial and relational analysis. "Serial analysis" ranks traders[1] by their total number of suspicious trading instances within a given time period. "Relational analysis" identifies networks of traders by examining the correlation of suspicious trading instances. Unexpectedly, the analysis showed that these seven individuals and their associated hedge funds had traded together prior to certain acquisitions.

The SEC now seeks to automate the entire Bluesheet process so that they can quickly analyze trading by multiple parties across multiple securities and compare those trades to the material information available to the public. The automation of the Bluesheet process will dramatically change the traditional enforcement model because it will allow the SEC to actively detect insider trading, rather than having to passively wait for referrals to investigate. Because the SEC will have the universe of trades at its fingertips, they will also likely be able to identify more sophisticated and subtle instances of insider trading.

The lesson from *Galleon* is that your phones may be under surveillance. Although this is important, it is not nearly as earth-changing as the takeaway from *Stephanou*: If the Bluesheet process is automated, then all of your trades—and all trades, by any trader—may be under surveillance at any time.

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[1] Here, "trader" is a term of art. A trader is a unique account number or a unique tax identification number. The account number or tax identification number is then linked to the individual or organization that controls the number.

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C. SEC v. Cutillo, *et. al.*

On November 5, 2009, the SEC announced insider trading charges against nine defendants who were allegedly part of a ring of Wall Street traders and hedge funds that engaged in serial insider trading. The SEC claims that one of the defendants, an attorney at Ropes & Gray LLP, tipped the other defendants about pending corporate acquisitions in return for kickbacks. The defendants made more than $20 million by trading ahead of the acquisition announcements.

The SEC's complaint alleges that Arthur J. Cutillo, an attorney in the New York office of Ropes & Gray, misappropriated material, nonpublic information from his law firm concerning at least four corporate acquisitions or bids involving firm clients. Cutillo, through another defendant, allegedly passed this information on to a proprietary trader at a broker dealer – known by some in the insider trading ring as "the Octopussy" because he had "arms" in so many sources of inside information.

According to the SEC, the defendants' went to great lengths to conceal their scheme. For example, the SEC alleges that defendants used disposable cell phones to avoid detection. After one of the acquisitions at issue had been publicly announced, one of the defendants is alleged to have destroyed the disposable cell phone he had provided to his tippee by removing the SIM card, biting it, breaking the phone in half, throwing away half the phone, and instructing his tippee to get rid of the other half.

D. SEC v. Chen Tang, *et. al.*

On October 30, 2009, the SEC charged the former CFO of a private investment firm, the CFO of a venture capital fund, and five of their relatives and friends with serial insider

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trading in two securities. The defendants allegedly earned more than $8 million in illicit profits.

Chen Tang, the CFO of the private investment firm, misappropriated material, non-public information about earnings announcements and market-moving purchases of Tempur-pedic International. The SEC alleges that Tang and others in the ring made about $2 million by trading on the information. The ring also traded on information misappropriated by Mr. Tang's brother-in-law, the CFO of a private investment firm.

The SEC alleges that the defendants tried to cover their suspicious trading by lying about their access to non-public information and their relationships with each other, among other things. In fact, Mr. Tang went so far as to deny knowing his own brother-in-law.

E. SEC v. Cuban

The industry should be particularly interested to see how the cases described above progress, because the SEC may not always get their man. On November 17, 2008, the SEC charged Dallas Mavericks owner Mark Cuban with insider trading. They alleged that he sold the stock of an Internet search engine company after he acquired material, non-public information concerning an impending stock offering that would be conducted at a discount to the prevailing market price. Mr. Cuban allegedly avoided $750,000 in losses as a result of his sales.

The SEC alleged that Mr. Cuban became privy to the information because he was the company's largest shareholder. They also alleged that Mr. Cuban agreed to keep the information confidential, but traded on it nonetheless.

However, a federal district court in the Northern District of Texas dismissed the case. The court found that an agreement to maintain confidentiality, without an agreement not to trade, is insufficient to support liability under Rule 10b-5. This was a blow to the SEC,

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which has long adopted the position that third parties who accept material, non-public information on a confidential basis are precluded from trading on the information.

Although this case seems promising for information recipients, do not make plans to rely on the Cuban defense just yet. The SEC recently appealed this case to the Fifth Circuit so the lower court's decision may not stand.

It is likely that these cases are merely the beginning of the crackdown. As a recent Director of the SEC's Division of Enforcement noted: "Insider trading cases are a high priority for the Commission…the Commission will aggressively pursue illegal trading whenever it occurs." The SEC is backing up these tough words by making concerted efforts to improve their ability to detect insider trading, both by adopting the new investigatory methods showcased in the Galleon case and by taking the first steps toward automating the Bluesheet process.

That means that this is an excellent time to carefully assess your own trading practices and remediate, if necessary. In particular, you should:

- Review, and if necessary strengthen, your company's insider trading policy;
- Encourage awareness of and compliance with insider trading laws and improve employee education and training to prevent inadvertent violations;
- Evaluate procedures for handling material nonpublic information and limiting the circle of access to those who truly "need to know;"
- When dealing with consultants or other third parties, consider obtaining representations that they are not conveying material nonpublic or otherwise confidential information;
- Consider the advantages and disadvantages of limiting personal trading by employees;
- When disclosing information that is potentially material and nonpublic, consider obtaining the recipients agreement to keep the information confidential and to not use it for any trading purpose; and

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- Consider restricting employees' ability to sit on corporate boards, thereby limiting their access to inside corporate information.

II. Asset Valuation

Given the beating that the market has taken for the past several quarters, the SEC has expressed particular interest in how advisers are valuing their illiquid and difficult-to-price securities. The SEC is concerned that advisers may be tempted to misstate the fair value of their assets (particularly if an asset's value is declining) so that they can generate higher investment advisory fees, preserve their reputational interests, attract and maintain clients, and even cover up Ponzi schemes.

The SEC has recently prosecuted firms for improper valuations. For example, on August 13, 2009, the SEC filed a complaint against two investment advisers and their advisory firm in SEC v. Brantley Capital Management, LLC et. al.. The SEC alleged that, in order to generate advisory fees, the defendants overvalued two assets that together comprised more than half of an investment portfolio that they managed.

More specifically, the SEC alleged that the defendants: invested in two private companies that they knew were in severe financial distress, concealed the companies' financial condition and certain third-party valuations from their fund's board, auditors, and investors, and knowingly gave false rationales for their over-inflated valuations.

It is likely that the SEC will become even more active in this area. In her Fall 2008 presentation to the National Society of Compliance Professionals, Lori Richards, then Director of the SEC's Office of Compliance Inspections and Examinations ("OCIE"), specifically addressed the issue of valuation. She noted that, although valuation is not a new issue,

> Examiners will be paying special attention to compliance in [this area]…Reluctance to fair value or mark down prices cannot take

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> precedence over the firm's pricing procedures—investors and fund shareholders have a right to know the current value of their holdings…This is an area where your focus is needed now—be sure that your firm is implementing its controls and its oversight over pricing.

Chairman Schapiro in January 2010 named Carlo di Florio, a partner in the Financial Services Regulatory Practice at PricewaterhouseCoopers, to lead OCIE. The current expectations are that di Florio will continue to emphasize fair pricing and valuation. Therefore, it would be wise to revisit your firm's valuation policies at this time. In particular, you should consider:

- The policies that govern how your assets are valued.
  - Do your policies comply with the relevant accounting rules?
  - Under your policies, what are appropriate bases for a valuation (e.g. quotes or prices on actual transactions, a broker's willingness to trade at that price, etc.)?
- Whether there are any exceptions to your valuation policies.
  - If so, what triggers the exceptions?
  - Who determines whether a triggering circumstance exists?
  - Is there any check on that determination (e.g. by a Valuation Committee)?
- Who makes the valuation determination for your assets.
  - Do you have multiple sources for pricing information?
  - If the valuation is made by a manager or other employee, do you have an entity (such as a Valuation Committee) to check their determinations?
- How often your asset valuations are revisited.
  - Are different classes of assets revalued on different schedules, based upon the predicted volatility of the assets' value?
  - Could you have a stale price issue?
  - If an employee suspects that you have a stale price issue, is there an established procedure she can follow to report her concern?
- Whether the actual prices that you realize upon sale the sale of an asset are fairly consistent with the valuations that you gave that asset prior to sale.

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- If there are wide gaps between the sale price and the valuation, what accounts for the discrepancy?

III. New SEC Custody Rule

In 2009, stories regarding numerous Ponzi schemes (notably those orchestrated by Bernard Madoff and Robert Allen Stanford) and other frauds flooded the media. The SEC perceives that, in light of the many financial scandals exposed this year, the investment community has grave doubts about whether the assets they entrust to investment advisers are actually safe. In response to investors' concerns, the SEC has adopted new custody rules that promote independent custodial arrangements by heightening the regulation of investment advisers who maintain physical custody of client assets. According to SEC Chairman Mary Schapiro, the new rule applies "additional safeguards where the safeguards are needed most—that is, where the risk of fraud is heightened by the degree of control the adviser has over the client's assets."

The SEC previously defined "custody," and that definition is still applicable under the new custody rule. An adviser has custody of client assets when it holds, "directly or indirectly, client funds or securities or [has] any authority to obtain possession of them." To clarify this definition, the SEC provided three examples. An adviser has custody of client assets if:

- It takes possession of the assets, even temporarily. Thus, if an adviser takes possession of client funds in order to forward the funds to a broker, then the adviser has custody of client assets.

  The SEC has created a safe harbor to protect advisers who inadvertently receive client assets, provided that the adviser returns the assets to the sender within three business days of receipt.

- It has the authority to access funds or securities from the client's account for any purpose other than authorized trading. Therefore, an adviser has custody of client assets if, for example, it can withdraw advisory fees or other expenses directly from the client's account.

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- It acts in any capacity that gives it legal ownership of, or access to, client assets. For example, this situation can arise if an adviser is both the general partner and investment adviser to a limited partnership. As general partner, the adviser probably has the authority to dispose of the assets in the limited partnership's accounts. If the adviser has this authority as general partner, then the adviser has custody of client assets.

If an investment adviser maintains custody of client accounts, they will be subject to two important requirements:

- *First*, they will have to retain independent public accountants to conduct a yearly "surprise exam" to verify that the assets exist.
- *Second,* they will be required to obtain a SAS-70 report from an accountant registered with the Public Company Accounting Oversight Board (PCAOB). A SAS-70 report details the controls the adviser has in place and provides results of controls testing.

Advisers can avoid these requirements by placing client assets with a third party custodian, provided that they reasonably believe that the client's custodian delivers account statements directly to the client.

Given the SEC's marked interest in custodial arrangements, their strong preference for third party custodians, and the potentially costly requirements the new rules place on advisers that maintain custody of their clients' assets, it may be prudent to reexamine your own custodial arrangements before the rules go into effect.

IV. Conclusion

Following a period of difficult criticism, the two SEC divisions most relevant to the adviser and fund industry, the Division of Enforcement and OCIE, are working to become stronger enforcers and better protect investors. Advisers and fund managers would be well-advised to revisit compliance policies and internal controls particularly in those areas where the SEC has sharpened its focus.

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