

K&L GATES



**Issues Arising from SEC  
Investigations of Private Fund  
Managers: How to Prepare for an  
Investigation and How to  
Maximize the Odds of Obtaining  
Insurance Coverage**

May 2, 2013

# Agenda

- Trends in SEC Investigations of Private Fund Managers
- Minimizing Risk Through Compliance
- Overview of D&O and E&O Policies
- Trends in Insurance for Hedge Funds and Managers
- How to Maximize the Odds of Obtaining Insurance Coverage for SEC Investigations

## Panel

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# Trends in SEC Investigations of Private Fund Managers

# SEC Enforcement Now Regulating Funds and Advisers

- Asset Management Unit formed in 2010
- Largest unit / in-house experts
- Liaise with OCIE, IM, RiskFin
- Huge case production in 2011 and 2012

# Regulatory Morphing

- Move away from a regulatory model
- Enforcement cases instead of deficiency letters
- Enforcement setting the agenda for OCIE and IM
- Focus on big monetary fines, criminal referrals
- Criminal prosecutor as SEC Chair

# Danger Zones – SEC Enforcement and Examination Focus Areas

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- Valuation
- Mutual fund fee initiative
- Problem adviser initiative (qualifications, AUM, past performance)
- Suspicious performance initiative
- Risk and strategy disclosures
- Self-dealing / allocation of trades
- Insider trading
- Expense allocation
- Adviser registration as broker-dealer

# What to Do on Learning of an Investigation

- Who to notify
- Forming the response team
- How to proceed

## Who to Notify

- General Counsel
- Managing body (board)
- Key executives
- Carrier
- Investors (review of side letters)
- Counterparties
- Selective disclosure issues
- Use of a PR firm (confidentiality issues)

# Forming the Response Team

- Legal expertise – inside, outside
- Technical expertise – inside, outside

## How to Proceed – Early Steps

- Document preservation
- Deactivate routine email destruction
- Identify and secure key records and files
- Any suspensions of employees pending inquiry?

# Getting on Top of the Situation

- Outside counsel to investigate to preserve privilege
- Achieve early understanding of basic facts and chronology
- Assemble and analyze core documents and records
- Interview key personnel – attorney notes to preserve

# Common Mistakes in Dealing with SEC Staff

- Fail to affirmatively cooperate with investigation
- Fail to affirmatively identify and fix any problems
- Inaccuracy or shading in representations to staff
- Failure to update staff on production problems / untimely responses

## Benefits of Credibility with SEC Staff

- Reasonable limitations on production scope and timing
- Negotiated search terms for email collections
- Potential to avoid action against entity and/or key executives
- Soften the blow if there is a problem

# Minimizing Risk Through Compliance

# Your Focus

## Reviews: Valuation, Performance and Expenses

- Annual Compliance Reviews
  - More frequent review of high risk areas
  - Change in testing procedures
- Investor Communications
  - Complaints or questions from investors
    - Identifying potential problematic trends
- Changes in Process
  - Rationale for procedural changes
- Peer Group Information
- SEC Releases

## Respond and Remediate

# Valuation

The staff will . . . focus on the accuracy of advertised performance, including hypothetical and backtested performance, the assumptions or methodology utilized, and related disclosures and compliance with record keeping requirements. Where feasible, the staff will also review changes in advertising practices related to the JOBS Act, which requires modification of the rules restricting general solicitations.

- Advertising
- Assumptions
- Methodology
- Disclosures
- Records

<http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf>

## Valuation (cont'd)

### Potential Risk Areas for Private Fund Advisers

- Pricing procedures are applied inconsistently
- Third party pricing agents assign inaccurate values
- Fees are calculated inaccurately due to inaccurate pricing
- Employees can override pricing with insufficient oversight
- Pricing errors are not corrected promptly or reviewed for materiality

# Valuation (cont'd)

## Additional Risks

- Writing up values to affect interim performance reporting to databases
- Writing up asset values during fund raising periods then writing them down following fund closure
- Writing up asset values to increase fees

# Valuation – What Can You Do?

## Periodic Reviews

Establish a Valuation Committee

- Consider a variety of individuals for inclusion, including the CCO
- Ensure the Committee meets regularly
  - Determine frequency by risk and reporting intervals
- Don't blindly rely on the auditors or the administrator
- Document your reviews
- Review valuation policies and procedures annually
  - Discuss risks and errors or other issues that arose during the year

## Disclosures to Clients and Investors

Describe your valuation policies and procedures in Part 2 of Form ADV and ensure consistency with disclosure in the Private Funds' PPMs and Limited Partnership Agreements as well as marketing materials (such as DDQs)

# Performance

What does your fund performance look like?

- Does it beat the industry indices?
- Does it do so consistently over time?

**Yes?**

- Congratulations the SEC may be knocking on your door soon

## Performance (cont'd)

“In 2009, the SEC began developing a computer-powered system that now analyzes monthly returns from thousands of hedge funds. Officials won't say exactly how it works or how much it cost to build, but the agency has announced four civil-fraud lawsuits filed as a result of what it calls the aberrational performance initiative....”

▪ *Source: SEC Ups Its Game to Identify Rogue Firms, Wall Street Journal, December 27, 2011*

# Performance (cont'd)

## The SEC's Aberrational Performance Inquiry

Broad SEC initiative to combat fraud in hedge funds

→ Proprietary software

→ Risk analytics

→ Aberrational:

- Constant outperformance of markets / indexes
- Steady performance in volatile market environments

Impact after 13 months:

- Seven total cases, most recently several weeks ago
- Expanded to mutual funds and private-equity funds



## Performance (cont'd)

“The analytics put Yorkville front and center on our radar screen. When we looked further we found lies to investors and the firm’s auditors as well as a scheme to inflate fees by grossly overvaluing fund assets. We will continue to pursue hedge fund managers whose success is based on fiction rather than fact.”

Bruce Karpati, Former Chief of the SEC Enforcement Division’s Asset Management Unit. “SEC Charges Hedge Fund Adviser and Two Executives With Fraud in Continuing Probe of Suspicious Fund Performance,” SEC press release, 10/17/12

<http://www.sec.gov/news/press/2012/2012-209.htm>

## Performance (cont'd)

“All of these models have a tendency to identify a significant number of false positives. There are a lot of people out there that may appear to have characteristics that we want to look at that, but upon further investigation, you determine nothing is really amiss.”

Craig Lewis, Director of the SEC's Division of Risk, Strategy and Financial Innovation, Compliance Intelligence, Regulatory Talk: Craig Lewis, SEC, 07/22/12

## Performance (cont'd)

- The data provided to third party databases is being captured, maintained, and analyzed by the SEC
- False positives will certainly occur
- Firms must be ready to defend their performance:
  - Do we have the records to support the performance we are reporting?
  - Do we feel comfortable with HOW we have calculated performance?
  - Do the disclosures we have accompanying our performance adequately describe what we are doing?
  - Do these disclosures adequately describe causes of particularly good (or bad) performance during a period that may not continue?

## Performance (cont'd)

### Misrepresentations of performance

- Review materials prepared by marketing department
- Records substantiating performance are required to be kept for 5 years from the last time they are used
- Test performance calculations

# Asset Verification

Routine part of most examinations, even when client and custodial arrangements appear to present a low risk of theft or misapplication:

- The initial document request list will typically ask for information and assistance in obtaining records directly from custodians and counterparties
- 3 levels: aggregate level (low risk), client level (medium risk), and wire transfer/account statement level (high risk)
- Contacting clients (will not reveal who, or what groups of clients)
- Contacting brokers (may do through website)

## Expenses and Fees

SEC focus on expenses in presence exams, regular exams and enforcement inquiries looking for:

- Shifting expenses to fund from adviser
- Broken deal expenses
- Fee layering

## Expenses and Fees (cont'd)

Management fees are charged to run the adviser, the adviser manages the fund and its investments, where do you draw the line?

## Expenses: What Can You Do?

- Be familiar with the governing documents
- Keep involved in what is happening at the deal level
  - Review ledgers at the fund level and firm level
  - Look for cross billing
  - Ensure that firm has adequate documentation (1) to back up management firm charges back to a fund, and (2) to confirm that charges match up with the disclosures regarding the expenses the fund will bear

# What Can You Do? (cont'd)

## In-Depth Risk Reviews

- Integrate compliance risk and overall risk management

## Implement appropriate policies and procedures

- Ensure they address the types of risks in your business model

## Involve a variety of personnel

- CCOs, CFOs and COOs may be able to add insight into risks and act as a conscience check

## Use your conflicts mechanisms

- Limited Partnership Advisory Committees are there to assist

## Identify and Resolve Issues Promptly

- Ensure that issues are resolved promptly

## Be Prepared and Cooperate

- The SEC will inquire or examine at some point

# Overview of D&O and E&O Policies

## Overview of D&O and E&O Policies (cont'd)

- Insurers often issue a single D&O/E&O (professional liability) policy to an adviser, which also often covers certain funds
- D&O Policies typically cover Loss arising from Claims alleging a Wrongful Act, but often exclude Claims related to “professional services”
  - Wrongful Act is often defined broadly to include any acts, errors, omissions, negligence, breaches of duty, misstatements, etc.
- D&O Policies often include:
  - Side A coverage for Non-Indemnified Loss of Insured Persons
  - Side B coverage for Loss incurred by an insured entity to indemnify an Insured Person
  - Side C coverage for Loss incurred by an insured entity, which may be limited to certain types of Claims

# Overview of D&O and E&O Policies

- E&O Policies typically cover Claims alleging Wrongful Acts related to “professional services,” such as:
  - Investment Advisory Services (e.g., giving financial, economic, or investment advice regarding investments)
  - Hedge Fund Services (e.g., services performed in connection with the operation or management of a hedge fund)

# Overview of D&O and E&O Policies (cont'd)

Coverage typically includes Defense and Indemnity:

- Defense: Certain policies require insurer to defend; certain policies permit policyholder to defend, subject to insurer's duty to reimburse Defense Costs
  - There are frequent disputes on selection of counsel, billing guidelines, reasonableness of fees, right to independent counsel, need for separate counsel, etc.
- Indemnity: Definition of "Loss" varies:
  - It generally includes "damages"
  - It may or may not include "punitives"
  - May exclude "Loss" that would violate "public policy" (insurers focus on "disgorgement")

## Overview of D&O and E&O Policies (cont'd)

### Claims that May Trigger D&O/E&O Coverage Include:

- Allegations of misrepresentations, negligence, breaches of fiduciary duties
- Allegations of negligent failure to investigate investments
- Allegations of improper valuation, improper use of side pockets, or improper allocation policies
- Allegations of mishandling of accounts
- Whistleblower allegations of Wrongful Acts
- SEC investigations concerning the above

# Overview of D&O and E&O Policies (cont'd)

What is the Trigger Point in the definition of Claim?

- Some policies do not cover investigations at all
- Some policies cover Insured Persons only
- Some policies apply upon issuance of formal order or service of subpoena
- Some policies apply upon service of a subpoena and when there is some indication that a proceeding may be commenced against an Insured
- Some policies apply after Wells notice is issued
- Some policies apply if there has been a request for a tolling agreement
- Some insurers have recently started to cover informal investigations or pre-claim inquiries

# Trends in Insurance for Hedge Funds and Managers

# State of Insurance Market – Liability Insurance for Hedge Funds and Managers

- Professional Liability/D&O Insurance
- Side A

## Increased Liability

- SEC formal investigations
- Lawsuits from investors
- Fraud

# Regulatory Investigations and Actions

- Insider trading
- Securities lending and borrowing transactions
- Use of side pockets
- Improper use of information from PIPE transactions
- Ponzi schemes
- Market manipulation
- Fraudulent misrepresentation to investors

## Recent Regulatory Settlements

- **Side Pockets** – Misappropriation of investors' money by illegally side pocketing investments - \$14 million settlement – does not include legal defense fees
- **Insider Trading** – Galleon Management LLC - \$64 million judgment as well as estimated \$40 million in legal defense fees
- **Fraudulent Misrepresentation to Investors** – Recommending hedge funds to investors - \$5 million judgment – does not include legal defense fees

# Investor Suits

- Regulatory, insider trading (even employee having inappropriate contact with someone)
- Poor performance, prolonged loss of alpha
- Strategy drift
- Headline risk
- Position sizing
- Fee calculations
  - Lender liability and loan servicing E&O
  - Activist exposures
  - Exposures associated with owning property
- An underlying fund or manager could be a Madoff
- Failure of the due diligence process
- A third party you relied on in the due diligence process failed
- Fees are too high
- Allocations were wrong
- Failure to oversee

## Market Trends

- Pension/Endowment Funds demanding insurance and/or higher limits before investing for both Fidelity Bonds and D&O Insurance
- Tightening of pricing average 5-10% premium increases on flat renewals (no increase in assets etc)
- Higher Retentions on high profile funds, particularly those with headline risk; high Regulatory Assets Under Management, Activists

## Pension Lawsuits

- State of CT sues Forstmann Little and Company for allegedly losing \$125 mm of State Pension funds with investments inconsistent with its contract
- AFTRA Retirement Fund and others settle with JPM for \$150 mm over breach of fiduciary duties, improper due diligence for hedge funds allocations
- Louisiana Pension Funds sues Fletcher Asset Management for \$100 mm losses
- Alabama Pension Fund sues SAC Capital for damages to their investment as a result of alleged illegal trading

# Potential Issues with Insured Persons of Manager or Fund Relying Only on Corporate Indemnification

- Entity may face legal restrictions on ability to indemnify or, depending on facts, may elect not to indemnify
- Ability to indemnify may be impacted by bankruptcy, fund closure, or illiquidity
- To the extent Fund has individual officers/directors, Fund may elect not to indemnify due to investor relation issues
- Ability or willingness to indemnify may vary with respect to advancement of defense costs versus settlements
- SEC may oppose indemnification in certain circumstances, but generally does not regard the maintenance of D&O insurance to be contrary to public policy
- SEC much more focused on making guilty directors & officers pay in the form of compensation clawbacks

# Benefits of Side A Coverage for Insured Persons

- Side A coverage generally responds to the non-indemnified Loss of Insured Persons
- Side A coverage may be included in policy issued to entities, but also may be issued as a stand-alone policy protecting only certain insured persons
- Stand-alone Side A coverage may have certain benefits
  - No coverage for entity, so policy limits cannot be exhausted by entity
  - No coverage for entity, so the policy cannot be considered an asset of the bankrupt corporation's estate
  - Policy can only be cancelled due to non-payment of premium
  - Non-rescindable for fraudulent acts
  - Broader definition of Loss / Insureds
    - Includes D&Os, In-house GC, Comptroller, Risk Manager
    - Expressly includes exemplary, punitive and multiple damages where permissible by state law
  - No retention if the company rightly or wrongly refuses to indemnify
  - Narrow Exclusions
    - Insured vs. Insured
    - Dishonesty
    - Personal Profit/Remuneration

# Whistleblower Coverage

## SEC Investigations and Proceedings

- Whistleblower tips likely to lead to formal and informal SEC investigations and proceedings

## Exclusions

- Whistleblower carveback to Insured v. Insured Exclusion
- Underlying conduct may be subject to the conduct exclusion, but look for “final adjudication” or similar trigger

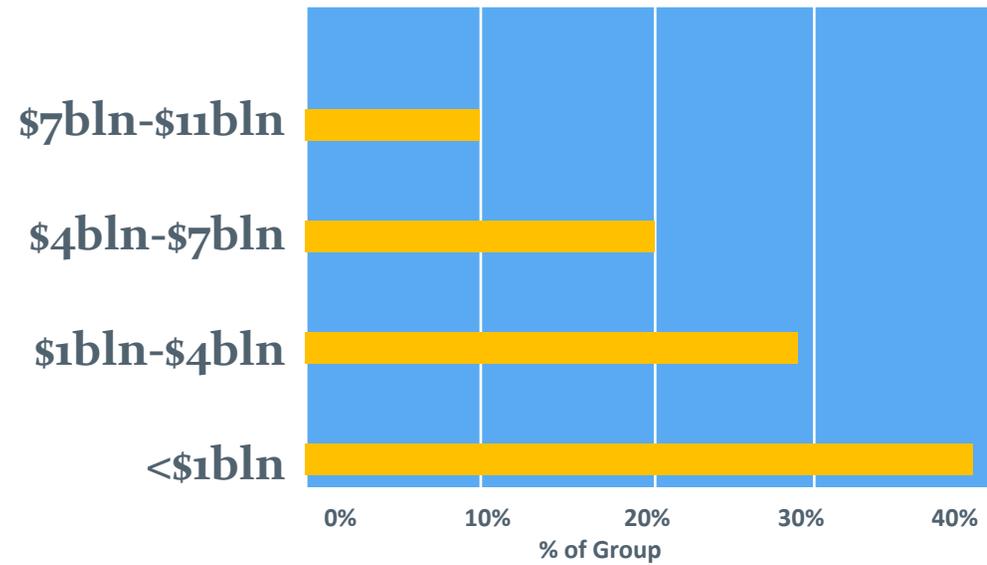
## Fines & Penalties

- Fines and penalties are often excluded from the definition of “Loss,” and may be uninsurable

## Defense Costs

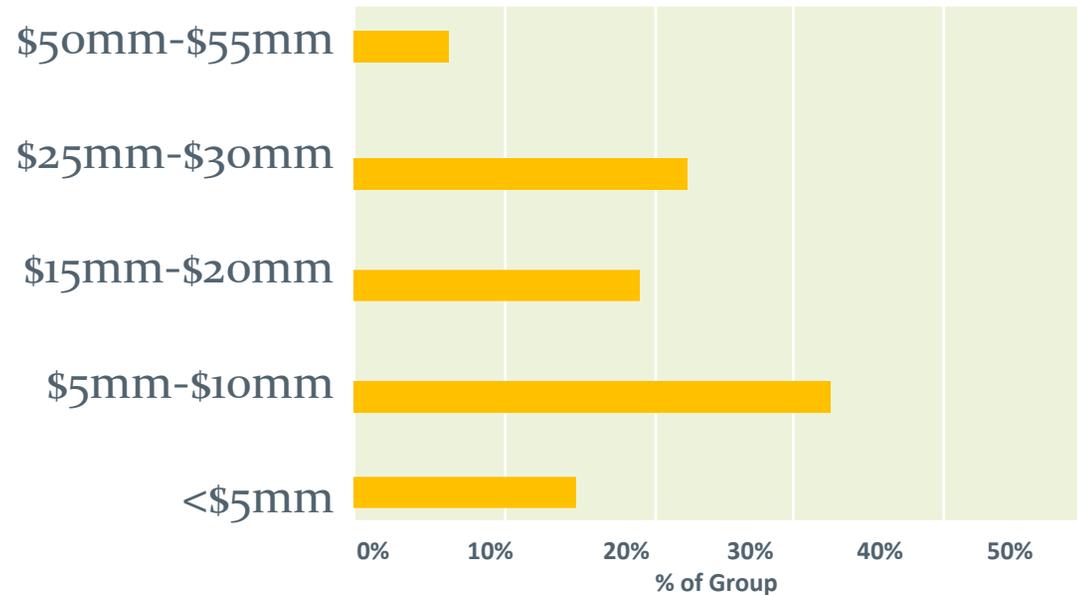
- Likely to be a large component of regulatory claims

# Peer Group AUM



Peer Group Size: 34

# Professional Liability Limit\*



\*Limits for funds with up to \$1bln in AUM. Limits represent total limits including Side A.

Peer Group Size: 34

# How to Maximize the Odds of Obtaining Coverage for SEC Investigations

# Key Steps to Maximizing Coverage for SEC Investigations

1. Know What is in Your Policy – policy language addressing the scope of coverage for SEC investigations varies widely
2. Be Prepared to Contest an Insurer's Denial of Coverage
3. Engage Your Insurers and Avoid Procedural Defenses (late notice / lack of cooperation)
4. Negotiate the Best Available Terms at Renewal

# Disputes with Insurers

- Court decisions vary widely based on specific policy language and facts of each case
- Decisions highlight need to be prepared to dispute an insurer's initial denial of coverage
- Decisions highlight the fact that, notwithstanding the well-known SEC enforcement process, some insurers continue to use language that arguably is not clear in SEC context
  - Some policies cover investigations, provided there is a written statement from regulator that an insured is a target
  - But SEC generally does not issue “target” letters. See SEC Enforcement Manual, Section 3.3.2 (“the SEC does not have targets of its ... investigations”)
- Many courts will interpret policy language in light of reasonable expectations of policyholder and will construe ambiguities against the insurer in order to promote a finding of coverage

## Disputes with Insurers (cont'd)

- *MBIA v. Federal Ins. Co.*, 652 F.3d 152 (2d Cir. 2011)
- Issue: Does a subpoena issued by the New York Attorney General trigger coverage? Insurer argued that the subpoena was not a Claim because subpoenas are “mere discovery devices”
- Policy: “Securities Claim” includes “formal or informal ... regulatory proceeding or inquiry commenced by the ... formal or informal investigative order or similar document”
- Held: Subpoena is a Securities Claim
  - Reasoning that a business person would view a subpoena as a formal or informal investigative order or, at a minimum, a similar document
  - Rejecting insurer’s “crabbed view” that a subpoena is a “mere discovery device”; rather it is the “primary investigative implement in the NYAG’s toolshed”

## Disputes with Insurers (cont'd)

- *National Stock Exchange* (N.D. III. 2007) – Part 1
- Policy: “formal regulatory proceedings commenced by formal investigative order”
- Issue: After formal order issued, insurer denied coverage on grounds that an SEC investigation was not a proceeding (on the grounds that the SEC defined investigations and proceedings differently)
- Held: Court rejected insurer argument that formal order did not trigger coverage (“if a formal investigative order did not commence a formal ... proceeding, then the term ‘formal investigative order’ as used in the policy would have no meaning”)

## Disputes with Insurers (cont'd)

- *National Stock Exchange* (N.D. Ill. 2007) – Part 2
- Policy: “formal regulatory proceedings commenced by formal investigative order”
- Issue: Insurer also denied on grounds that coverage was limited to Insured Persons and Formal Order did not identify any specific Insured Persons and did not allege Wrongful Acts
- Held: Insurer must pay:
  - Reasoning that prior SEC correspondence stated that they were investigating directors and officers (and policy did not require identification of any specific individual)
  - Reasoning that Formal Order – which stated that Staff had information suggesting that violations “may have been committed” – satisfied any requirement of an alleged Wrongful Act

## Disputes with Insurers (cont'd)

- *Office Depot, Inc. v. National Union*, 2011 WL 4840951 (11<sup>th</sup> Cir. 2011)
- Issue: Whether the entity was entitled to coverage for an SEC investigation (informal and/or formal stages)
- Policy:
  - Insured Persons were covered for regulatory investigations: (1) once such person was identified in writing as a person against whom a proceeding may be commenced, or (2) service of subpoena by SEC
  - For Organization, Policy covered only Securities Claims, which was defined to exclude regulatory proceedings and investigations, but then restored coverage for certain regulatory proceedings against the Organization so long as such proceedings also named an Insured Person
- Insurer conceded coverage for Insured Persons post-subpoena
- Policyholder argued that “proceeding” was ambiguous and should be construed to include a formal investigation against entity
- Held: When policy expressly distinguishes between a proceeding and an investigation, the court will not construe the term “proceeding” to include an investigation

## Disputes with Insurers (cont'd)

*J.P. Morgan v. Vigilant Ins. Co.*, Order dated 12/13/2011  
(*NY Appellate Dep't, First Division*)

- Facts: SEC accused Bear Stearns of late trading and market timing; Bear Stearns did not admit liability, but settled for \$215MM; Administrative Order labeled \$160MM of remedy as disgorgement
- Insurer denied (ill-gotten gain); policyholder argued that “disgorgement label” was not determinative and, in fact, the payment in large part constituted covered compensatory damages
- Trial Court: Denied carrier’s motion to dismiss / Order’s use of term “disgorgement” not determinative
- Appellate Division: Granted judgment to insurer / when “read as a whole” it appears that payment was disgorgement
- Lessons: Avoid labels where possible / coordinate efforts

# Mitigate Process-Based Defense

- Once policy language is set, the availability of coverage turns on the application of the specific contract terms to the specific facts at issue
  
- Policyholders cannot always control the facts, but policyholders should be mindful that insurers often attempt to rely on procedural defenses to attempt to avoid otherwise valid coverage claims:
  - Notice (notice of claim)
  - Cooperation (strategic issues / conduct of defense)
  - Consent (selection of counsel, settlement negotiations)
  
- Goals: Mitigate defenses and educate insurer about potential exposure, costs of litigation, risks of going to trial, reasonableness of settlement opportunities, etc.

# Negotiate Best Available Policy Terms

- In the D&O/E&O market, insurers often are willing to negotiate policy terms (which may or may not impact premiums)
- Small changes can be outcome determinative
- In part, this practice arguably arises from the fact that many insurers just started to issue new forms for this industry sector in the past few years, and there is a need to tailor the forms to specific insureds
- Arguably, given anticipation that insureds will seek to negotiate, insurers often do not include their best language in their standard forms

# Conduct Exclusions – With Carvebacks

## (Address Criminal Activity, Fraud, Ill-Gotten Gains)

- Many policies include a “fraud” exclusion, but many exclusions do not apply to alleged fraud and/or coverage for defense costs
- The trigger point in the exclusion is critical, and has evolved over time to the benefit of policyholders
- The later in a timeline the trigger is, the better for the insured
- Examples:
  - Trigger exclusion at the very allegation of fraud (worst for insured)
  - Trigger when fraud is found to have “in fact” occurred
  - Trigger when fraud is evidenced by an adjudication
  - Trigger when final, non-appealable adjudication in the underlying action
- In many policies, the exclusion should NOT apply to bar coverage for a settlement and the insurer would be precluded from re-litigating the issue of whether “fraud” occurred in a coverage lawsuit

# Other Terms to Consider

- Regulatory Investigations
- Defense Costs – Advanced/Allocated
- Order of Payments
- Severability Clause (Innocent Insureds)
- Limits and Retentions
- Worldwide Coverage
- Hammer Clause
- Outside Directors Coverage
- Run Off Coverage

# Summary

- Insurance coverage is a valuable corporate asset
- In order to maximize such asset, policyholders should:
  1. Be prepared for “no” from insurer at outset and be prepared to contest denials
  2. Proactively involve insurer and pressure insurer to participate
  3. Mitigate procedural traps
  4. Negotiate best possible terms on renewal