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Insider Trading

Proskauer Partner and SEC Enforcement Division Veteran Ronald Wood Explains the Implications for Hedge Fund Managers of Structure and Staffing Changes at the SEC

By Jennifer Banzaca

In the past few years, the SEC's Division of Enforcement (Division of Enforcement) has refocused its efforts with respect to the investment management industry via structure and staffing. On the structuring side, the Division of Enforcement has established specialized units, such as the Asset Management Unit, devoted to addressing investor and systemic risks raised by private funds and their managers. On the staffing side, the Division of Enforcement has hired investment management industry professionals – including hedge fund managers, analysts, operating professionals and due diligence experts – to staff these units. With this new-found expertise, SEC staff not only "know where the bodies are buried," but also "understand how they got there," according to Bruce Karpati, Chief of the Asset Management Unit. See "OCIE Director Carlo di Florio and Asset Management Unit Chief Bruce Karpati Address Examination and Enforcement Priorities for Hedge Fund Managers at the RCA's Compliance, Risk & Enforcement 2012 Symposium," The Hedge Fund Law Report, Vol. 6, No. 4 (Jan. 24, 2013). On the foundation of its new expertise, the Division of Enforcement initiated 147 enforcement actions against investment advisers and investment companies in fiscal year 2012.

To provide deeper insight and actionable analysis on what the structuring and staffing changes at the Division of Enforcement mean for hedge fund managers, The Hedge Fund Law Report recently interviewed Ronald Wood. Wood is a partner in the Securities Litigation Group at Proskauer Rose LLP, and prior to Proskauer spent a decade in the Division of Enforcement. Our interview covered topics including SEC enforcement priorities; the use of reports filed with the SEC to identify enforcement targets; the SEC's aberrational performance initiative; insider trading best practices; paid access to corporate executives; track record portability; due diligence on Chinese companies; pay to play issues; "big boy" letters; and FCPA concerns for hedge fund managers. This article contains the transcript of our interview with Wood.

HFLR: You spent a decade with the Division of Enforcement conducting and directing investigations and follow-up proceedings in matters involving insider trading and other commercial wrongdoing. In light of that experience, can you describe the role generally played by the SEC chairman in defining the Division of Enforcement's priorities, and specifically how you expect Mary Jo White (if confirmed) to impact enforcement priorities as they relate to hedge funds?

Wood: That is a two part question. First, you have a question about the role of the SEC's chair. Yes, the chair does have a say in the agency's priorities overall, but it's rare that a chairperson comes in with an agenda. The chair picks up and learns what the current priorities are and then, from the time they arrive, they move with what is happening in the markets. The SEC has to either be in front of those issues or get right on top of them if they have the potential to disrupt the system or in any way impact investor confidence or market performance. In other words, the chair doesn't typically reshape things, but they do have a say in the priority ranking of issues that are brought before the SEC for rulemaking, enforcement or market sweeps and education.

With respect to Mary Jo White, she is a known quantity. She is a very highly regarded and tough former prosecutor. She will likely continue the SEC's march toward more coordination with the U.S. Attorney's offices in various districts. The SEC has experience with former prosecutors leading offices and divisions and now you have the entire Commission being headed by a former prosecutor. I think that signals there will be a continued coordination with the criminal authorities in the prosecution of securities offenses.

HFLR: Drilling down one level from the Division of Enforcement generally to the Asset Management Unit specifically, what are you seeing and hearing with respect to the Asset Management Unit's concerns and enforcement priorities, especially in the private funds arena?

Wood: With the adoption of Dodd-Frank and the requirement that formerly exempted managers of private funds have to become registered, the SEC now has 1,500 new registrants in the private investment fund space, bringing the number of registered fund managers to around 4,000. The Asset Management Unit is the largest of the recently created specialty units within the Division of Enforcement. I think they have about 75 staff members and their job is to police this space. That group has made it clear that they're going to be developing risk analytics to find out where potential risk areas are in this new registrant population. They will be giving that close attention. To the extent the Asset Management Unit is part of the Division of Enforcement, ultimately the goal is to find cases warranting enforcement action. They are going to be looking to see if practices at hedge funds and private equity funds fall outside the federal securities laws and the SEC's rules. In the first instance, they will caution those folks and they are doing that now in the form of the recently announced presence exams. With respect to the 1,500 newly-registered private fund managers, a lot of them received letters introducing the SEC staff and the compliance process. These will be followed with examinations. In some of those exams, they will find issues, and to the extent they find recurring issues in a number of firms, they will define the issue as a new risk area. If the issue is outside the norms and the rules, you will likely see enforcement action.

The things they have specifically targeted include things like conflicts between the manager and either the limited partners or the funds in terms of compensation or opportunities; valuations; and zombie funds. I think you will be seeing that kind of action and focus.

Also, there will always be compliance issues. For example, if a fund has a private placement memorandum that describes how the manager will conduct the business, you can expect that the Asset Management Unit staff will be testing to verify that the fund's actual procedures and the way it runs the business are consistent with the private placement disclosure. This seems like a very simple thing but within these simple things you often find deviations. Some of these deviations can be more beneficial to the manager than the investors, which is a concern.

HFLR: Many private fund managers now have to file Form ADV and Form PF with the SEC. How does or will the Asset Management Unit use the information in these forms in the course of identifying enforcement targets and actually bringing enforcement actions?

Wood: First, you have to recognize the differences between the Office of Compliance Inspections and Examinations (OCIE) and the Asset Management Unit, which resides within Enforcement. OCIE will always consider publicly filed documents or documents filed with the SEC for any firm they examine. They will take into consideration representations in your Form ADV or your Form PF. They will verify that the statements are accurate. If the Asset Management Unit or Division of Enforcement is involved, it means that there is a reason to believe there could be a perceived violation of securities laws. In either case, the SEC staff will expect you to live up to what you have disclosed. The documents themselves may not be the basis of an enforcement action, but in the course of an enforcement investigation or action, they can be used as statements you have made that you are expected to abide by. If you're the subject of an enforcement action, everything about you that is available to the SEC staff can be used. However, just because you file a Form ADV or Form PF doesn't mean it will be used for enforcement purposes.

HFLR: Similarly, does the SEC's Aberrational Performance Inquiry mean that hedge fund managers that outperform some benchmark are more likely to become the subjects of enforcement actions, or does the inquiry involve a more nuanced understanding of what constitutes "aberrational performance"?

Wood: If the SEC identifies you as having aberrational performance, meaning that the average fund in your space, managing a similar asset class is performing one way but you are consistently performing another way, those cases will be closely reviewed. Such funds will be put into a bucket and there will be a suspicion that something is different about the funds, and the SEC will want to find out what that difference is. Being put into the bucket does heighten the possibility of potential enforcement action, but it doesn't mean there will be enforcement action.

The nuance is in determining what is causing the unique performance, whether it's something in your methodology or analysis. That determination will shape how the staff reacts and whether they pursue enforcement action. This focus comes out of the Madoff situation. Remember, he was aberrational in that he was so consistent. Other funds were up and down in different market cycles, yet the Madoff funds were consistent, which was aberrational.

HFLR: Are prosecutors seeking – in their charging documents, plea negotiations, use of wiretap evidence or via other methods – to "move the goalposts" of what constitutes criminal conduct by hedge fund managers?

Wood: For a long time, criminal resources were not devoted to Wall Street offenses to the same extent as bank robberies and hijackings. But, more recently, that has begun to change, most prominently because of the seeming prevalence of insider trading, and public demand for harsher treatment of financial offenders. Insider trading has always been a notoriously difficult area to police because so much of it is so subjective. You can't get the phone call or meeting where inside issues were discussed unless someone confesses. I think prosecutors reached a point of frustration where they believed very strongly that inside information was being passed but didn't have the tools to get to it. So, they decided to employ criminal techniques by using informants and wiretaps. A treasure trove of cases has resulted from these techniques, including the Galleon case and others related to it.

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The success of those prosecutions shows the marketplace and investors that the government will take steps to prevent the U.S. markets from being tilted in favor of one group over another. If prosecutors are able to interrupt illegal activity or deter others from drifting into it, they will continue to use these techniques. They are not expanding the types of conduct that is criminal, just adopting criminal techniques to what had heretofore been a kind of gentleman's environment with people who had been given the benefit of the doubt about having business ethics and would conduct themselves appropriately. That has been found not to be the case, and prosecutors are now using hardball techniques to investigate these activities.

HFLR: On a related topic, what are two or three best practices for private fund managers seeking to avoid insider trading violations when engaging expert network firms or political intelligence firms?

Wood: The first thing I would advise is to be aware that there have been indictments and prosecutions of people who were part of expert networks. If you're going to put yourself in that position, be aware that at some level there could be someone who is part of that group who is either passing material non-public information or receiving it. You definitely need to be aware the SEC and criminal authorities are collaborating and there may be wiretaps or informants and that those persons may be part of the networks, as well.

If you believe there is some value in participating in those calls or those meetings knowing these facts, do your independent diligence; have a reason for why you are participating in the calls; know what specifically you want to add to what you know; and have a diligence file showing that you already have been studying a particular industry or company or develop a file so that if you are later questioned, you can show that you had a legitimate reason for accessing the expert network. I would also advise managers to maintain their own independence and professional distance from people in the networks. What can happen is people can start to form alliances in these networks, and some people start to feel an obligation to give as much as they sometimes get. That is where people can begin to have motivations to take steps beyond what is acceptable business diligence.

HFLR: The Financial Times recently reported that some U.K. hedge fund managers are paying significant hourly amounts to prime brokers in exchange for access to the brokers' corporate clients, in some cases without the knowledge of the corporate client. Have you seen hedge fund managers and prime brokers – in the U.K., the U.S. or other jurisdictions – employing this "corporate access" model and, if so, what compliance concerns does it raise and how can managers address those concerns?

Wood: I personally have not had experience with this. I think the analogy we have here are the expert networks: those present corporate insiders who talk about their companies. How each of them get involved with those networks, whether through prime brokers who are being paid by hedge fund managers to bring them in or otherwise is anybody's guess. But, that is our parallel. Again, I would say that if you are going to be using an expert network or these "corporate access" programs, there are two risks that automatically exist. One is that inside information is being trafficked, and the other is that someone is listening or will be sharing this with the government. Separate and apart from that, you may be curious as to how this corporate person is able to do this and whether or not their corporation is a supporter of their involvement and whether the person is being compensated. You may ask directly, which would be the soundest practice, so that everyone is clear about potential conflicts and what is going on. Ultimately, if you're going to use these services, you have to have legitimate and specific reasons for doing so.

HFLR: Now, onto a few questions arising out of your recent, relevant litigation experience. First, regarding performance information and related advertising issues: If a "star" portfolio manager at a prominent hedge fund management company wishes to break off and start his own firm, what are the circumstances under which that star manager can use the track record of the funds he managed at the old firm in marketing the new firm?

Wood: I think that the best thing that a person considering that move should do is to consult with counsel who knows the SEC literature on this. There are a number of no-action letters that the SEC has issued on this subject. The GIPS standards also talk about this issue. [See "A Step-By-Step Guide to GIPS Compliance for Hedge Fund Managers," The Hedge Fund Law Report, Vol. 4, No. 44 (Dec. 8, 2011).]

For an individual, it would seem to be a pretty high hurdle to use the performance from your prior fund. You would have to establish that you were principally or primarily responsible for achieving the results. How do you do that? There are a number of factors the SEC and other entities look at to determine the nature of your involvement. Four factors come to mind that can be useful in assessing how strongly you can make that claim: (1) who raised the funds and sourced the deals; (2) who conducted the diligence to vet potential investments the portfolio would make; (3) who then managed those investments once they came into the portfolio; and (4) how was the investment closed out and who was involved. It is very rare that one person can claim to have done all of that. So you potentially will always have a conflict. It can be done and there have been cases where people have shown that they were the chief cook and bottle washer. Those are rare. So, it's best to have the guidelines and look back and evaluate all of the investments in the portfolio that achieved the result you want to use as a track record to determine your role in raising the fund, sourcing and diligencing the deals and managing the assets.

This is a priority area for the SEC. The Asset Management Unit will be looking at claims of past performance with old funds to determine if you are using a track record you really don't have the right to claim. One of the best things you can do is get an agreement with the firm you are leaving that you can use the track record. There may be limitations but that is the best way to be sure you can use a track record. If you don't and you claim it, you not only run the risk of having a commercial fight with the firm you've left, or others at that firm, but you may ultimately have the SEC at your doorstep.

HFLR: In light of your experience with Chinese companies with a nexus to the U.S., what financial or operational due diligence tips would you give to hedge fund managers evaluating an investment in an NYSE-listed Chinese company or a Chinese reverse merger company?

Wood: I don't think we're going to see a lot of reverse merger companies going forward. Those have fallen into disfavor. It would be the really audacious and risk-loving managers who see potential opportunity there. If someone were to be considering a reverse merger company, they should know that one risk is, as we have seen, the companies were not ready for prime time. They did not have good infrastructure or they were not sufficiently sophisticated from a financial or management standpoint to withstand the kind of regulatory and disclosure regime that exists here in the United States. Some of them have been shown to be just fraudulent. In my experience with reverse merger companies, some can be real companies with legitimate business but the executives within the company were either unsophisticated and not surrounded by more sophisticated people, or people trained in or attuned to U.S. law and regulation. But, as I say, I think that that trend is fading and those companies have begun to fade in popularity.

The NYSE-listed Chinese companies are a little different because those came by way of a listing, typically a public offering. You probably want to look at who is on the board and if they are familiar with the U.S. marketplace and the U.S. regulatory structure. You want to know whether the board members, in their own right, are people who have strong backgrounds and reputations who would be expected to have a strong hand in guiding management. You want to know if they are the kind of board member who would confront management if questionable issues arise. If you have those kinds of personalities on a company's board, that is probably a company that has lower risk of having the kinds of problems the reverse merger companies have had. Also, you want to look at the quality of management to determine whether these are people who have a demonstrated record of making positive contributions to the company; who know their business; and who understand what it takes to grow a business and to grow it within a regulatory scheme that requires you to have a compliance culture. If those factors are present, then you just do your basic business/investment analysis.

HFLR: Can you describe the pay to play regime governing commodities fund managers and their third-party marketers?

Wood: The SEC promulgated a rule a couple of years ago that has affected who can make campaign contributions. I'm not aware of the CFTC taking similar steps. But, the issue is the same: if you are relying on third parties to get you access to someone who has a public office, you need to be very careful how those people present you and what you do in exchange for those introductions. I would suggest it is probably better to accept intelligence from them and to make all approaches directly, that way they are not acting as an intermediary such that compensation to them might be perceived as filtering back to the public official or in some way improperly influencing the process. I have seen a lot of those cases and this issue has come under the microscope pretty intensely. I would say you should consult with counsel before engaging a third party marketer to make sure you understand the proper scope and put limits on the third party to make clear where the lines are.

HFLR: Do federal securities laws generally, and insider trading laws specifically, apply to trades between hedge fund managers in private company stock, bank debt or trade claims?

Wood: I don't think trade claims are securities. But, private company stock and bank debt are securities, and the federal securities laws can be invoked even in private transactions. You can also have traditional common law fraud claims.

HFLR: Along similar lines, assume that hedge fund A owns stock in a private company; holds a seat on that company's board; and, as a board member, receives nonpublic, negative sales projections for the company. Hedge fund A wants to sell its stock in the private company to hedge fund B, but is concerned that hedge fund B will sue it (hedge fund A) for federal securities fraud, insider trading or state law fraud. In this circumstance, can hedge fund A effectively protect itself with a "big boy letter"?

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Wood: There's no definitive answer to that. "Big boy" letters are well-known, and they are used between big, sophisticated investors to do transactions. One of the elements of fraud is reliance. The "big boy" letter says that one party has information the other party may not have but the party with less information is not relying on the other party to make their investment decision because they have done their own research and diligence. In that way, "big boy" letters try to remove the element of reliance. The courts are divided on this as to whether it is a sufficient defense against a claim to the seller in your hypothetical. Some courts say securities laws do not allow you to do this. The SEC has said it doesn't matter if there is a "big boy" letter, it will not stop the SEC from taking enforcement action if they believe there has been improper activity in connection with the transaction.

HFLR: Should hedge fund managers be concerned about the FCPA when marketing to sovereign wealth funds?

Wood: The FCPA requires that an issuer of securities to the public accurately record its books and records – its intakes and outflows of cash. One of the ways to fight corruption is to make sure that all monies paid out are accurately accounted for. On the one hand, when you're a hedge fund manager, you're typically a private entity and not a reporting company. If you're marketing to a sovereign wealth fund, you're trying to get a mandate to manage assets for another investor. It doesn't seem like a natural place for FCPA issues to arise. However, if in your portfolio you have companies that are doing business in other places, you have to be careful about their practices because those things may affect the performance of those assets. The hedge fund manager itself, at some point, could change hands, be acquired or take on a partner or investor who would be relying on the books and records being accurately kept. If there have been expenditures made in connection with marketing to sovereign wealth funds that are questionable or not accurately recorded, then you could have an FCPA issue. The FCPA has come to represent a big, broad push towards more accurate accounting of financial transactions as a way to defeat corruption in foreign jurisdictions.

HFLR: Along similar lines, how can private equity fund managers best navigate the FCPA concerns raised by retaining "deal finders," sourcing agents or similar intermediaries in non-U.S. jurisdictions?

Wood: That's a prime area to be concerned about. Whenever you are using a third party to help you develop or procure a relationship in another country, obviously there is some expectation that at some level there is compensation paid for those efforts. That compensation, while legitimate, can be a way that the ultimate target of the efforts receives some benefit. In other words, to get the attention of the person in charge of some government agency or affiliate in another country, the third party takes them out to dinner or gives them something of value, and you are ultimately paying for that – either through reimbursement or compensation – so you have to be careful. You need to define what they are going to do, who they are going to meet with, what will be said and given, and then make a decision from that. Having other people acting on your behalf in a culture you may not understand, with business ethics that may not be in line with your own, you have to really be circumspect. You have to be very clear in your communications, and you have to make clear that you don't pay for access to people or to secure deals. You need to be smart about this. In many places, money is the great equalizer, and people tend to pass it around in order to get attention from decision-makers. You need to have a tight rein on your agent, and accountability.