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CHIEF COMPLIANCE OFFICERS

Commissioner Gallagher's Dissent in SEC Enforcement Action Against Hedge Fund Manager Misses the Mark

By Robert E. Plaze

Stroock & Stroock & Lavan

On June 18, 2015, SEC Commissioner Daniel Gallagher took the unusual step of publishing a statement explaining why he had voted against two proposed settlements for enforcement cases against investment advisers, each of which alleged fairly serious violations of the federal securities laws.[1] See "*SEC Commissioner Speaks Out Against Trend Toward Strict Liability for Compliance Personnel*," The Hedge Fund Law Report, Vol. 8, No. 25 (Jun. 25, 2015). Gallagher did not seem to be moved by these violations. He was, however, deeply troubled that the SEC's Enforcement Division sought to hold both firms' chief compliance officers (CCOs) responsible under Rule 206(4)-7, the so called "Compliance Rule" under the Investment Advisers Act of 1940 (the Advisers Act).

Gallagher's concern was that the SEC's enforcement cases are "trending toward strict liability for CCOs," despite the fact that Rule 206(4)-7 fails to identify any specific responsibilities for a CCO other than to administer the adviser's compliance policies and procedures. He lays blame on the rule itself, which he believes is not a "model of clarity," and on the failure of the SEC to provide additional guidance in the eleven years since the rule was adopted.

In a guest article, Robert E. Plaze, a partner at Stroock & Stroock & Lavan, discusses Gallagher's statement, the BlackRock enforcement action and Rule 206(4)-7. Because it is the more interesting case of the two settlements Gallagher voted against, this article addresses only the SEC administrative action against BlackRock, followed by a discussion of Gallagher's criticisms of Rule 206(4)-7.

For additional insight from Plaze, see "*Stroock Seminar Identifies Five Strategies for Mitigating the Risk of Supervisory Liability for Hedge Fund Manager CCOs*," The Hedge Fund Law Report, Vol. 7, No. 2 (Jan. 16, 2014). For more from Stroock, see "*Aligning Employee and Investor Interests Under the Volcker Rule*," The Hedge Fund Law Report, Vol. 7, No. 21 (Jun. 2, 2014); and "*How Can Offshore Hedge Funds Ensure That Section 10(b) Will Apply to Their Transactions in Securities Not Listed on U.S. Exchanges?*," The Hedge Fund Law Report, Vol. 5, No. 13 (Mar. 29, 2012).

BlackRock Advisors

The BlackRock enforcement action alleged that an investment adviser failed to disclose a conflict of interest involving the outside business activities of Daniel J. Rice, III, a highly successful portfolio manager.[2] While managing the energy sector portfolios of several BlackRock registered funds and other clients, Rice formed and funded a family-owned and controlled oil and gas production company in violation of BlackRock's restrictions on private investing. Among other things, the oil and gas company entered into a joint venture with another company that was held in some of the BlackRock portfolios he managed. Rice was thus situated to use his position with BlackRock to benefit his oil and gas production company to the detriment of BlackRock clients.

According to the SEC, BlackRock's CCO, Bartholomew A. Battista, became aware of Rice's outside business activities and issued a written direction instructing him to restrict these activities and requiring pre-approval before he could engage in others. The CCO subsequently approved a number of such additional business activities involving raising

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capital for the family oil and gas company but failed to follow up to determine whether the portfolio manager had complied with the written directions. The potential conflict came to light in an article published in The Wall Street Journal, which presumably caught the attention of the SEC.[3]

The SEC's primary allegation was that BlackRock violated the anti-fraud provisions of the Advisers Act by failing to disclose the conflict of interest to its clients, including the boards of certain mutual funds advised by BlackRock. The SEC also alleged that BlackRock failed to adopt and implement adequate compliance procedures to prevent violations of the Advisers Act and asserted that the CCO was liable for having "caused" that violation. Although the SEC release is a bit fuzzy about what would have constituted appropriate policies and procedures, the SEC was clear that it believed that the CCO's failure to monitor or otherwise enforce the terms of the specific directions given to Rice constituted a failure to implement a compliance policy.

The SEC also asserted a violation of Rule 38a-1(a)(4) under the Investment Company Act of 1940, which requires a CCO of a registered fund to at least annually report to the fund's board "material compliance matters," defined by the rule to include violations of federal securities laws; violations of a fund's policies and procedures; and any other compliance matters about which the fund's board would reasonably need to know to oversee fund compliance.[4] Assuming the facts as laid out in the SEC release, the fund's CCO had an obligation under the Compliance Rule to inform the fund boards of Rice's violation of BlackRock's private investment policy and his conflict of interest. The CCO's failure to do so would appear to be a clear violation of the Compliance Rule. This is the first time the SEC has brought an enforcement action against a CCO under this particular provision.

For more on the Blackrock enforcement action, see "*SEC Settlement Highlights Circumstances in Which Hedge Fund Managers Must Disclose Conflicts of Interest*," The Hedge Fund Law Report, Vol. 8, No. 16 (Apr. 23, 2015).

Rule 38a-1(a)(4), which has no counterpart in Rule 206(4)-7 under the Advisers Act, is the only provision in either rule that imposes a specific duty on a CCO. Thus, it is puzzling that Gallagher should choose this as a case on which to dissent because of the lack of clarity as to the CCO's responsibilities. Given the case the Enforcement Division had under Rule 38a-1, it is surprising that it didn't offer to drop the Rule 206(4)-7 allegation to secure Gallagher's vote – assuming the staff was aware of his objections before the vote was completed and the dissent was published.[5]

While the clarity of the BlackRock fund CCO's obligations did not seem to be in doubt in the SEC enforcement action, that the SEC ultimately brought the enforcement action against Battista is peculiar since he was the CCO to the adviser only – not the fund – and thus did not have an obligation under Rule 38a-1. Instead, and without any explanation, the SEC asserted that BlackRock and Battista caused the fund's CCO to fail to disclose to the fund's board. The public is left to speculate what happened. This is, of course, part of the mystery of a negotiated settlement – what actually happened may be known only to the parties and the SEC chose not to share it.

Rule 206(4)-7

Rule 206(4)-7 was adopted by the SEC in 2003 in the wake of the late trading and market timing scandals involving advisers to mutual funds.[6] It imposes an obligation on investment advisers to establish compliance policies and procedures; to appoint a CCO to administer such policies; and to review the effectiveness of the policies at least annually. It is not surprising that the rule does not provide for specific responsibilities for the CCO, because the rule itself imposes obligations only on the adviser; a CCO cannot violate the rule.

The SEC, therefore, brings its enforcement cases against CCOs under separate sections of the Advisers Act which give the SEC authority to sanction a person for "aiding and abetting" or "causing" a violation of the Advisers Act.[7] Contrary to Gallagher's suggestion, the SEC staff

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has provided helpful guidance as to the circumstances under which the Enforcement Division will recommend this type of enforcement action against a CCO.

In May 2014, Andrew Ceresney, the SEC's Director of the Enforcement Division, gave a speech in which he explained that such circumstances include when the CCO (1) affirmatively participated in the misconduct; (2) helped mislead regulators; or (3) had a clear responsibility to implement compliance programs or policies and wholly failed to carry out that responsibility.[8]

This is a most reasonable standard. If the Enforcement Division and SEC Commissioners do no more than adhere to these principles, CCOs need not fear that they will be inappropriately targeted. Most of the cases bought by the SEC against CCOs so far involve fairly egregious compliance lapses and would seem to meet Ceresney's criteria, although undoubtedly the defendants in those cases would have a different perspective.

Gallagher's dissenting statement succeeded in agitating CCOs and drew an unusual rebuttal from another sitting SEC Commissioner, Luis A, Aguilar.[9] Aguilar asserted that the agency brings relatively few cases against CCOs, pointing out that a number of the cases it does bring involve a CCO acting in a different capacity, e.g., as an adviser's CEO. He explained that the Commissioners do not lightly bring cases against CCOs, and he was aware of Mr. Ceresney's speech explaining staff criteria for bringing actions against CCOs. See "*SEC Commissioner Issues Statement Supporting Hedge Fund Manager Chief Compliance Officers*," The Hedge Fund Law Report, Vol. 8, No. 28 (Jul. 16, 2015).

Gallagher might want to focus his considerable energies on another provision of Rule 206(4)-7 where enforcement appears to have gone off track. Paragraph (a) of the rule requires registered investment advisers to adopt and implement policies and procedures reasonably designed to prevent violations by the adviser and its personnel of the Advisers Act. Too often today, the Enforcement Division appears to engage in a reverse engineering application of the rule.

Enforcement's assumption seems to be that if a violation of the Advisers Act occurred there must have been inadequate policies and procedures because, after all, had there been adequate policies and procedures, no violation would have occurred. Once the adviser has conceded the underlying violation, there is little incentive for it to contest the staff's allegations of its violation of the Compliance Rule, but this is how bad law is made.[10]

Most violations occur because of the error, negligence or misdeeds of an employee of an investment adviser that, in retrospect, could have been prevented. But Rule 206(4)-7 does not require that type of hindsight. Rather, the rule only requires policies and procedures that are reasonably designed to prevent violations of the Advisers Act. Whether a policy or procedure is required under this standard would seem to turn on whether there is a reasonable risk that a violation will occur and the magnitude of the consequences to the adviser's clients if it did. The reasonableness must turn on facts known before the violation occurred, not after. The latter interpretation would be unreasonable.

That Rule 206(4)-7 does not require perfect hindsight does not mean that reasonableness should be measured as of the date the adviser's compliance policies and procedures were written. In the release adopting Rule 206(4)-7, the SEC discusses the need for interim reviews of an adviser's policies and procedures, and the appearance of red flags would obligate the adviser to adopt or revise policies that it might not otherwise be expected to have.[11] Conversely, the absence of red flags could relieve an adviser's obligation to have a policy.

Cost must also be a factor, because it would be unreasonable to require an adviser to spend $10 to uncover a $1 fraud. The SEC must surely appreciate that each adviser could build a firm that might be impermeable to non-compliance but which would not financially float. The SEC was sensitive to the cost of compliance when it adopted Rule 206(4)-7 in 2003; the SEC's compliance and enforcement staff must be sensitive to it now.

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In some cases an adviser will be almost entirely dependent on information provided by its employees or third persons. For example, advisers require employees who are "access persons" to report brokerage accounts, securities holdings and transactions to comply with their codes of ethics requirements and to guard against front-running and other breaches. Absent red flags, the Compliance Rule should not be interpreted to require advisers to engage in a forensic exercise to try to discover unreported holdings or transactions. The costs could be extraordinary and the effort often fruitless given the difficulty of discovering, for example, brokerage accounts that are designed not to be discovered.

Sometimes non-compliance just happens, despite an adviser's reasonable efforts. As discussed above, it's easy for the SEC staff to settle an action asserting a compliance violation when the staff has established a violation of another rule or statute, but the staff should think carefully about whether bringing such an action is appropriate. First, the adviser's compliance personnel involved will be professionally damaged even if they are not personally identified. Second, the cumulative effect of the findings of inadequate policies and procedures in these types of SEC settlements will make (and have already made) it impossible for an adviser or its counsel to understand what is required, short of building the equivalent of a compliance battleship (the cost of which may end up sinking the adviser).

Conclusion

Rule 206(4)-7 has worked well for advisers, CCOs, clients and the SEC since it was adopted in 2003. It has fostered a new professionalism in the compliance community and has given CCOs an important weapon to combat misbehavior by people who manage an awful lot of investor money. Appropriately brought enforcement actions by the SEC against bad CCOs help the good ones by stiffening their spines to resist pressure to look the other way. The problems with the SEC's administration of the rule lie not in its expectations of CCOs, but its application of the policies and procedures requirement.

Robert E. Plaze is a partner in the Washington, D.C. office of Stroock & Stroock & Lavan. He counsels investment advisers and investment companies on regulatory and compliance matters arising under the federal securities laws. Before joining Stroock, he served as Deputy Director of the Division of Investment Management of the SEC.

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[1] "*Statement on Recent SEC Settlements Charging Chief Compliance Officers with Violations of Investment Advisers Act Rule 206(4)-7.*"
[2] BlackRock Settlement Order (Apr. 20, 2015). All facts recited are as set forth in this release.
[3] Jason Zweig, "*Can 'Skin in the Game' Pose Conflicts?*" The Wall Street Journal (Jun. 1, 2012).
[4] Rule 38a-1(e)(2).
[5] The BlackRock settlement was announced on April 20, 2015; Commissioner Gallagher published his dissent two months later on June 18, 2015.
[6] Investment Advisers Act Release No. 2204 (Dec. 17, 2003).
[7] Sections 203(e)(5) and 203(k)(1). As noted above, the enforcement action against Battista alleged that he "caused" a violation of the Compliance Rule.
[8] "*Keynote Address at Compliance Week 2014*," May 20, 2014.
[9] "*The Role of Chief Compliance Officers Must Be Supported,*" June 29, 2015.
[10] One lawyer at a meeting recently observed, "It's amazing what people will settle to."
[11] Supra n.6.

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