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TRUMP ADMINISTRATION

Pro-Business Environment of New Administration Continues to Have Challenges and Pitfalls for Private Funds

By Michael Washburn

While the election of Donald J. Trump as U.S. president in November 2016 has proved one of the most divisive events in modern political history, many observers shared a consensus that the new administration could adopt a pro-business, anti-regulation stance, to the benefit of the financial industry and investment funds. As months passed and top positions at the SEC remained unfilled, uncertainty spread and concerns arose that the hard line of former Commission Chair Mary Jo White would continue in spite of the pro-business rhetoric. With the recent appointments of Jay Clayton as SEC Chair and Dalia Blass as Director of the Division of Investment Management, the contours of the new regulatory regime are finally becoming discernable. Chair Clayton provided further clarity by publicly outlining his guiding principles in a recent address to the Economic Club of New York.

To help readers understand the current regulatory environment, and the implications of recent and ongoing changes to private fund regulation, The Hedge Fund Law Report has interviewed Seward & Kissel partners Patricia Poglinco and Robert Van Grover about an array of issues, including the SEC's rulemaking agenda in 2017 and beyond; the fate of the Financial CHOICE Act of 2017; the Commission's willingness to revisit and reexamine its policies and rules; the reliance on whistleblowers for enforcement purposes; the methodology that regulators will use to root out irregular trading patterns and activities; and the state of cybersecurity defenses and enforcement. These are among the issues that Poglinco, Van Grover and their colleagues will explore in greater depth at the upcoming "Private Funds Forum" co-hosted by Seward & Kissel and Bloomberg BNA to be held on September 27, 2017.

For a prior interview with Poglinco and Van Grover, see "How Studying SEC Enforcement Trends Can Help Hedge Fund Managers Prepare for SEC Examinations and Investigations" (Sep. 8, 2016).

HFLR: Now that we are a number of months into the new administration, do you see private funds experiencing a less stringent and more pro-business environment? Has the new administration lived up to the hype and to its promises?

Poglinco: It is eight months in, and from where we sit, it is still too early to tell. The rhetoric is there. The agenda of the newly appointed Director of Investment Management should shed some light on the future regulatory stance of the SEC with respect to the investment management industry. We will soon get a sense of what her priorities are from a rulemaking standpoint and in terms of whatever rulemaking was pending when the changeover occurred.

Van Grover: Clearly, the tenor is much better. Last year, about this time, we were right at the precipice of several new rules being adopted and more being proposed that were going to be adopted before Chair White exited. The moment President Trump was elected, however, everything was put on hold. While we have not seen the promised deregulation, we have certainly moved away from a "broken windows" policy. This administration is clearly more pro-business. We have not seen new initiatives, the way we might have expected, with President Trump's party being in control of both houses of Congress, but we certainly have seen the pendulum stop swinging in favor of overregulation.

When you consider the guiding principles Chair Clayton articulated in his speech, they are a dramatic change compared to Chair White's. His focus is on our capital markets and restoring them to their position globally. That is a pretty significant departure from Chair White. He is very pro-business and pro-capital formation.

[See "SEC Chair Clayton Details Eight Guiding Principles for Enforcement and Agency Strategies for Their Implementation" (Aug. 10, 2017).]

Poglinco: All we have to go on thus far are the remarks in Chair Clayton's speech and some testimony to Congress that was given in June 2017. The speech was, to some degree, a response to the "core principles" that the new administration articulated with respect to regulation of the financial system. He did mention the asset management industry in that speech, and I think the inference is that he intends to continue the protection of clients and investors through examinations by the SEC. I do not think that we are going to see any reduction in that area. He indicated that all the resources will be made available.

Who knows for certain what the prospects are at this time, but we do have the Financial CHOICE Act, which could have a significant impact on the private funds industry. It is unlikely that it will get through the U.S. Senate in its current form, but in terms of a wish list, it is impressive: rolling back the Dodd-Frank Act and other post-2008 regulatory restrictions; repealing the Volcker Rule; and there is also a provision in there that would create an exemption from SEC adviser registration for private equity managers.

[See "Financial CHOICE Act of 2017 Proposes Sweeping Reforms, but May Allow Regulators to Maintain Status Quo in Some Areas" (Jun. 1, 2017); and "How the Trump Administration's Core Principles for Financial Regulation May Benefit the U.S. Funds Industry (Part One of Two)" (Feb. 16, 2017).]

Van Grover: The act would also roll back the Department of Labor's fiduciary rule. It is too early to tell, but all of this certainly shows promise.

HFLR: Should we expect the SEC to pursue an aggressive enforcement agenda in the hedge fund space, as it has done in the private equity realm?

Poglinco: It has certainly been our experience that when we look at exam trends for our SEC registered investment adviser clients – particularly for private fund managers that are heavily concentrated in the hedge fund industry – a lot of the private equity themes that the SEC was focused on have clearly transferred over. For example, the intense focus on conflicts of interest and expense allocation policies and procedures. So, some of this has happened already. Whether it is going to continue remains to be seen.

Van Grover: There are a number of ways of looking at the issue. Is the SEC going to go away? No, of course not. The agency is going to continue to examine registered advisers. It will be looking at all of these issues on exams. What is the tone of those exams, however? Are they all right on the precipice of a referral to enforcement, or are they ending with deficiency letters? At least in the short window of time that we have seen, there has been more of an emphasis on deficiency letters and less of a race to enforcement. All of this is in line with the general change in tone that we noted above.

[See "BakerHostetler Panel Analyzes Shifts in Enforcement Policies and Tactics As Industry Anticipates New Administration and SEC Chair (Part One of Two)" (Jan. 5, 2017)].

Poglinco: One interesting point in Chair Clayton's guiding principles is that he wants the SEC to review its rules retrospectively. He noted that the SEC should be reaching out to outsiders to look for input, not just at the proposing and adopting stages but also at the way those rules are implemented and perhaps at the unintended consequences. It is an issue that the hedge fund and private funds industries have had to address – where you have regulations that do not fit neatly within the business model of a private fund manager and that are tremendously expensive for managers to adopt in the manner that the SEC expects that they will. That is a hopeful point, in terms of looking at regulation and regulatory activity in a more holistic way.

Van Grover: This is consistent with Executive Order 13772. It is what the President wanted all regulators to undertake – to reexamine their rules and to determine whether any of them should be repealed or refined in light of their costs to registrants. One of the things we have heard recently is that the CFTC is considering a possible amendment to Rule 4.13, which would be wonderful for private fund advisers.

[See "RCA Symposium Panels Discuss New CFTC and NFA Regulations Governing Obligations of Hedge Fund Managers Required to Register As CPOs or CTAs" (May 23, 2013).]

HFLR: Do you see a similar level of emphasis on whistleblowers as an enforcement tool as compared to last year?

Poglinco: The Office of the Whistleblower releases statistics about the level of referrals that come from that source. I can tell you that in many cases, issues come up where the SEC is looking around or inquiring about something, and the likely source for the inquiry is a whistleblower. I do not see that going away anytime soon.

Van Grover: It is now so much a part of the exam that the SEC is even examining a company's standard employment and separation agreements to be sure they do not have language that would prevent whistleblowing. The examiners look carefully at everything, including the manager's compliance manual and code of ethics, to be sure that the firm has adequately carved out the opportunity, so that people can blow the whistle without fear of retaliation. It is not just a tool that the Commission uses; it is now part of a routine exam.

[See "Lessons on Separation Agreements That Fund Managers Can Glean From Recent SEC Action" (Feb. 2, 2017.]

HFLR: The business continuity and transition plan rule proposal that came out a little over a year ago strongly emphasized operational risk as a compliance issue. Is there the same emphasis on operational risk at present?

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Poglinco: One thing we have noticed over the past 18 months or so, in a standard exam-request letter, is that the letter will request the adviser's compliance policies and procedures, as well as its operational policies and procedures. That is fairly new. Whether advisers have formal operational procedures or not is another question, but regulators are focused on those types of issues.

Van Grover: This rule proposal is one that I was referring to earlier, that looked like it was close to being adopted but is now languishing. The concern with the rule was not so much the emphasis on business continuity, because the truth is that, with or without the rule, through the exam process, the SEC has required managers to have business continuity plans in place for years. What was really dramatic was the rule itself. The challenge with the rule as proposed was that unlike a lot of rules that are broad enough to allow for customization, this rule had highly specific requirements that would be very expensive for smaller managers to adopt. One hopes that if it is dusted off again and adopted, it will be made a little less rigorous and more open ended to allow customization by managers based on their size and resources.

[See our three-part series on "Top Ten Operational Risks Facing Hedge Fund Managers and What to Do About Them": Part One (Oct. 18, 2012); Part Two (Nov. 9, 2012); and Part Three (Feb. 1, 2013).]

HFLR: Would you say that conflicts of interest continue to be an appropriate overarching concern for the Asset Management Unit of the SEC?

Poglinco: Without question. Conflicts of interest is a singular focus, and when you think about it, it touches so many different areas of an adviser's business. This is an area in which, even if the regulatory climate changes, I would not expect to see any change in emphasis or any reduction in the focus on conflicts of interest.

Van Grover: Advisers owe a fiduciary duty to their clients. They are supposed to make effective disclosure of conflicts. When advisers' interests diverge from those of their clients, the issue of disclosure becomes that much more important, and disclosures need to be more detailed.

HFLR: Last year, the International Limited Partners Association came out with a template that it had developed for partners to provide information about fees and expenses to investors. Was this a good idea?

Van Grover: This template puts everyone on a level playing field, but the difficulty with this standard is that it is more relevant for private equity fund managers, as opposed to hedge fund managers. I do not know that it lends itself in the same way to hedge funds. Maybe, over time, they will make modifications to it or incorporate suggestions so that it lends itself better to the hedge-fund space.

Poglinco: We have not seen any broad adoption of the template as of yet.

[See "How Managers May Address Increasing Demands of Limited Partners for Standardized Reporting of Fund Fees and Expenses" (Sep. 1, 2016).]

HFLR: Cybersecurity came up in Chair Clayton's testimony about priorities. Does this continue to be an urgent issue for private funds?

Poglinco: Absolutely. On August 7, 2017, the SEC's national exam program, led by the Office of Compliance Inspections and Examinations, issued yet another risk alert with observations from the cybersecurity exam initiative. That was the fourth formal communication on the subject in about three years. The Commission does not seem to be letting up on the pressure. I think the regulators are very worried about a really disruptive breach happening somewhere.

Van Grover: Client account information is, in and of itself, highly sensitive. The SEC has brought an enforcement action against an adviser, not even for the loss of funds, but merely for not having adequate procedures around cybersecurity. I agree that it is an urgent topic that not only the SEC and the CFTC, but all regulators internationally are paying close attention to. Whether a firm is highly resourced or barely resourced, I think this is going to continue to be an issue, much like conflicts of interest. Those who seek to attack continue to get greater capital and greater ability, so there is always an opportunity for them and to guard against it is very difficult.

Poglinco: The one piece of good news is that the August 2017 risk alert indicates that there had been progress. The exam staff looked at registered advisers, registered investment companies and registered broker-dealers. Through these sweep exams, the exam staff observed some improvement, which suggests that the SEC is getting its message across, but the broad view was that there was still work to be done.

[See "SEC Review of Cybersecurity Finds Gains Since 2014, but Cites Gaps in Training and Compliance" (Aug. 24, 2017).]

HFLR: The National Exam Analytics Tool (NEAT), developed by the SEC's Quantitative Analytics Unit, purportedly enhances the regulators' ability to detect trading patterns that in the past would have been harder to identify. How significant of a development is this?

Poglinco: I would say that it is a very important step that the agency has taken. A second critical step not to be overlooked is the way that the SEC has recruited experts to help it understand the industry, whether that means hiring people from the industry, or using consultants who have industry expertise. The exam teams are significantly more knowledgeable about the industry than in past years. The data analytic capability is tremendous.

Even in just a routine exam, the amount of data that is being requested is huge. Take, for instance, a firm's trade blotter information for a two-year or eighteen-month period. That is an enormous amount of information for a sizeable manager who actively trades, and there is no possibility that you can hold any of it back.

HFLR: Can you identify an area where there is still widespread compliance failure, or a lack of understanding on the part of fund managers of what practical steps to take?

Poglinco: You have to look at what issues are getting a lot of press, because that is what the SEC is looking at. For instance, there is currently a sweep exam program focused on social media and electronic messaging applications. I think that the detailed request letter that came out may have taken some advisers by surprise. It clearly shows that the SEC is focused on these issues. A letter like this one sometimes means that the examiners have stumbled on a real problem when examining someone or in some other setting. That is certainly an area that deserves some attention.

Van Grover: I would say the same about political intelligence and insider trading. It is always a significant portion of each year's enforcement actions, and always a key area of focus by the SEC on exams, and the SEC's recent enforcement actions involving political information clearly illustrate the agency's focus. The recent cases, including the recent decision by the U.S. Court of Appeals for the Second Circuit in U.S v. Martoma, are going to continue to focus the SEC's attention on insider trading and on the steps managers are taking to keep their policies and procedures current – for example, how they are tracking meetings with company insiders and other information sources.

Whatever policy an adviser adopts, it needs to conduct monitoring and forensic testing to make sure that it is complied with. Most managers conduct some form of email review, but advisers need to practice smart email monitoring, and not just look for the word "fraud" to see whether it comes up. Just as the regulators have gotten more sophisticated, their expectation is that so have the registrants.

[See "In U.S. v. Martoma, Second Circuit Eliminates 'Meaningfully Close Personal Relationship' Element Articulated in Newman for Insider Trading Prosecutions" (Sep. 14, 2017).]

Poglinco: All of these areas are potential sources of material nonpublic information. As the industry changes and uses new tools like big data, the expectation is that registrants will have examined their practices to make sure that they are in line with compliance obligations.

[See "SEC Insider Trading Action Highlights Red Flags Hedge Fund Managers Must Heed When Employing Political Intelligence Consultants" (Jun. 8, 2017); and "SEC Complaint Suggests the Agency Will Continue Aggressive Enforcement Actions for Insider-Trading Violations" (May 11, 2017).]

Van Grover: Another area of recent focus is pay to play, where the SEC has brought a number of enforcement actions, even for very small, incremental violations. That is something advisers need to keep in mind when they update their policies.

Poglinco: That is an issue that sometimes falls off the radar screens, and these administrative proceedings serve as a reminder.

[See "Campaign Contributions As Small As $500 Could Draw SEC Enforcement Action for Pay to Play Violations" (Jan. 26, 2017).]

HFLR: At the end of Chair Clayton's speech, he said that the best way for Main Street investors to protect themselves is to check out with whom they are dealing. How does this concept apply in the private funds space?

Poglinco: We certainly have seen a focus on that due diligence in the exam setting. It is very important in terms of research and data – where it is coming from, who is providing it and whether it contains personally identifiable information about actual persons. The SEC has an expectation that advisers understand those issues and have adapted their policies and procedures to address them.

[See "How Managers Can Identify and Manage Cybersecurity Risks Posed by Third-Party Service Providers" (Jul. 27, 2017).]

